THE DETERMINANTS AND EFFECTS OF FINANCIAL LIBERALIZATION IN SUB-SAHARAN AFRICA: A REGIONAL ANALYSIS WITH A CASE STUDY OF NIGERIA

A DISSERTATION SUBMITTED TO THE SCHOOL OF PUBLIC POLICY AND ADMINISTRAION, CARLETON UNIVERSITY, OTTAWA, ONTARIO
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF DOCTOR OF PHILOSOPHY

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OTTAWA, CANADA

MAY 2007

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395, rue Wellington
Ottawa ON K1A 0N4
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Your file Votre référence
ISBN: 978-0-494-33496-6
Our file Notre référence
ISBN: 978-0-494-33496-6

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ABSTRACT

This dissertation has three distinct but related objectives. The first objective is to provide insights into the determinants of financial liberalization in a sample of 30 countries in Sub-Saharan Africa (SSA). The second objective is to explore the factors that led the Nigerian government to implement financial liberalization. The third objective is to assess the impacts of financial liberalization in Nigeria.

Using a newly constructed database of financial liberalization, this dissertation shows that participation in an International Monetary Fund (IMF) program increases the likelihood of financial liberalization in the average country in the sample. Furthermore, there is evidence to support the learning hypothesis, which posits that a country is more likely to implement financial liberalization if a big country in the region (described as a regional leader) has implemented financial liberalization. Good economic performance, represented by increasing GDP, reduces the likelihood of financial liberalization in the average country. Similar to the cross-country evidence, case-study analysis shows that Nigeria's participation in IMF program was a significant factor leading to the implementation of financial liberalization in that country. In addition, the ideas and beliefs of senior policy makers in Nigeria constituted a significant factor leading to financial liberalization in that country.

This dissertation concludes that financial liberalization led to a phenomenal increase in the number of banks in Nigeria. However, the increase in number of banks did not result in significant improvement in most measures of financial development. On the other hand, financial liberalization facilitated the emergence of a new class of financially buoyant Nigerians outside the traditional military/political class.

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ACKNOWLEDGEMENT

Like all challenging tasks, the task of completing a dissertation and obtaining a Ph.D. requires the support and encouragement of others. Therefore, although I claim full responsibility for any errors that may remain in this dissertation, I am grateful to everyone who has contributed in one way or the other to ensure that I reach this destination. I thank my supervisor Dr. Dane Rowlands and members of my thesis committee, Dr. Saul Schwartz and Dr. Ted Jackson for all their assistance, guidance, and words of encouragement during this process. I would also like to thank Dr. and Dr. (Mrs.) Obijiofor Aginam and Emeka Ekwosimba for all the help they rendered to me during the course of this project.

I wish to express my sincere gratitude to members of my family who have, in various ways, borne the real cost of this journey. I thank my lovely wife, Ifeyinwa for her support during the good and bad days of my graduate studies. I would also like to thank my children, Chidinma, Chinenye, and Ogechi, all of whom gave up quality time with me so I may focus on this task. I remain grateful to all of you for your sacrifices. I cannot forget my family and friends in Nigeria, many of who displayed uncommon kindness to me during these past years.

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Chapter One

Introduction

Following the attainment of political independence, various countries in Sub-Saharan Africa (SSA) initiated strong controls over their respective financial sectors. These controls were meant to symbolize full independence in their political and economic spheres after years of colonial domination. During the colonial period, the financial sectors of SSA countries were dominated almost entirely by foreign banks. These banks were mere branches of European banks. The feeling that European banks were not interested in financing the development needs of the colonies spurred the newly independent governments to undertake extensive control of the financial sector. Therefore, government controls over the financial sector in SSA were not born out of any overriding economic principle, but reflected a "nationalist response to colonial practices" (Mkandawire 1999; p. 322).

Colonial banks in SSA were widely accused of discriminating against local businesses in their financing decisions. The colonial banks concentrated more on providing financial services to expatriate firms serving the interest of the colonial masters (Brownbridge, 1998). Given the feeling of discrimination by African nationals, it is little wonder that the immediate response of the governments of most SSA countries after political independence was to secure control of their respective financial sectors, and to influence all financial variables in order to steer the economy in a desired direction. The immediate post-independence era was therefore a period when government directly guided the flow of the economy – a phenomenon considered to be a sign of economic

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independence. Support for these levels of controls was also based on the belief that no meaningful development could be achieved without government controls.

Another reason for extensive government involvement in the financial sector was the practice of foreign donors. Government-run development banks were the major organs through which donor countries and agencies channeled development aid and foreign loans to SSA countries. This practice reinforced the need for development banks, and supported the provision of preferential credit to priority sectors. Furthermore, at the time many SSA countries attained independence, the international environment favoured state intervention in the development process. As Mkandawire and Soludo (1998) noted, state interventionism was as relevant to "the centrally planned economies of the East bloc as it was to their capitalist rivals in the West. It was also as true for the developing countries as it was for the developed countries" (p. 29). Therefore, SSA nationalist desires for state intervention were in line with the global order of that time.

By the late 1970s and early 1980s, the development paradigm that emphasized extensive government controls over the financial sector was under serious attack. The now famous McKinnon (1973) and Shaw (1973) argument subjected the old development thinking to ridicule. The McKinnon and Shaw (MS) thesis argue that controlling interest rates leads to low levels of savings and reduces bank credit and investment. According to this thesis, an administratively fixed interest rate is likely to result in a low or negative real deposit rate.[1] A low or negative real deposit rate would lead to an artificial scarcity of capital because households have no incentive to save under such an interest rate regime. In addition, controlled interest rates are alleged to limit appropriate risk-taking by financial institutions because such controls may make it impossible for financial

[1] The real deposit rate is the nominal deposit rate less the inflation rate.

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institutions to charge high interest rates for very risky projects. Therefore, in the view of McKinnon and Shaw, deregulation of interest rates would allow interest rates to increase to their natural equilibrium, and the increase in interest rates would bring about an increase in savings and investment. Similarly, government credit allocation guidelines were alleged to lead to an inefficient allocation of resources as banks make credit decisions not on the basis of economic considerations, but on government directives and political expediency. MS describes a regime of government controls over the financial sector as *financial repression*[2], and argue that such controls hinder the growth of savings and investment, and retards economic growth in general.

It would appear that the deteriorating economic conditions of many SSA countries accorded some level of legitimacy to the theoretical critiques of the development model practiced by these countries in the 1960s and 1970s. Against the background of a worsening social and economic climate, and based on the apparent condemnation of the prevailing economic policies by the international financial institutions, Sub-Saharan African countries had no other option but to consider some form of economic policy reforms. The most popular option at the time was the Structural Adjustment Program (SAP), a package of market-oriented reforms championed by the International Monetary Fund (IMF) and the World Bank.

The SAP contained a set of policy recommendations aimed at transforming African economies from government-dominated economies to private sector-led ones. One principal component of the SAPs in Sub-Saharan Africa was financial sector

[2] Financial repression is used to describe a financial system where there are extensive government restrictions preventing financial intermediaries from making decisions on the basis of market forces. It is usually characterized by: administratively determined deposit and lending rates, government guidelines on credit expansion and sectoral allocation, restrictive licensing of new banks, and a high level of government ownership of financial intermediaries (McKinnon, 1973).

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liberalization. Consequently, one of the most significant developments in SSA in the past few decades has been a steady move towards financial liberalization. For the purpose of this dissertation, financial liberalization and banking sector liberalization are used interchangeably, and entails a conscious effort to free a country's banking sector from pervasive government controls. It involves the relaxation of government controls over lending and deposit rates, the elimination of credit allocation guidelines for banks, and the relaxation of entry restrictions into the domestic banking sector.

This dissertation has three distinct but related objectives. The first objective is to provide insights into the determinants of banking sector liberalization in a cross-section of SSA countries.[3] The second objective is to explore the factors that led the Nigerian government to implement financial liberalization. The third objective is to assess the impacts of financial liberalization on the financial sector and political economy of Nigeria. In order to fulfill these objectives, this dissertation is organized in three separate sections. All the sections are linked by their focus on financial liberalization in SSA. The first section provides a cross-country study of the determinants of financial liberalization using a sample of 30 countries in SSA. Section 2 presents a case study of the determinants of financial liberalization in Nigeria, and Section 3 analyzes the effects of financial liberalization in the Nigeria.

1.2 Research Questions and Hypotheses

This dissertation will attempt to provide answers to the following research questions:

[3] For the purpose of this thesis, the determinant of financial liberalization is defined as those factors that affect the likelihood of financial liberalization in a given country.

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1) Why did SSA countries embark on banking sector liberalization after many years of government control? What factors affected the likelihood of financial liberalization in the region?
2) What forces led to the introduction of banking sector liberalization in Nigeria?
3) How has financial liberalization shaped the banking sector in Nigeria, and why did financial liberalization produce such results? Did financial liberalization produce any unintended effects in Nigeria?

Following from the above research questions, the hypotheses to be tested are as follows:

1) Sub-Saharan African countries implemented financial sector liberalization within the context of the Structural Adjustment Program, which was a principal conditionality of IMF facilities undertaken by these countries. Therefore, the presence of IMF programs in a country significantly increases the likelihood of financial sector liberalization in that country.
2) As in other SSA countries, financial liberalization was implemented in Nigeria when the country signed on to the IMF Structural Adjustment Program. However, circumstances surrounding Nigeria's implementation of the financial sector reforms suggest that domestic forces also played a significant role in Nigeria's decision to implement financial liberalization.
3) Although financial liberalization led to gains in a few areas of the financial sector, it led to crisis in the banking sector and produced other unintended results in Nigeria.

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1.3 Motivations and Contributions of the Study

The literature on financial liberalization is vast. However, researchers have focused mainly on assessing the effects of financial liberalization on financial development and economic growth. For example, Brownbridge and Harvey (1998), Bandiera, *et al.* (2000), Reinhart and Tokatlidis (2003) among others, have examined the effects of financial liberalization on financial sector development and economic growth in various countries. Similarly, Kaminsky and Reinhart (1999) and Demirguc-Kunt and Detragiache (2001) examine the links between financial liberalization and financial sector crisis.[4] However, only very little research has been done to explain the determinants of financial liberalization.[5]

Similarly, most studies on financial liberalization in developing countries have focused almost exclusively on the liberalization experience of countries in Asia, Latin America and some parts of Europe. Although SSA countries undertook similar financial sector reforms, researchers have generally paid little attention to the reform experience of these countries. The apparent neglect of the SSA experience is worrisome because it could lead to lack of understanding, or at best, incorrect understanding of SSA experience with financial sector reforms. At the extreme, incorrect understanding of SSA political economy could mean that foreign development partners such as the World Bank, the IMF and other donor/creditor nations may sometimes recommend wrong development policies to SSA countries.

This study seeks to bridge some of the gaps in the literature in the following ways. First, it provides not only an assessment of the effects of financial liberalization, but it

[4] Detailed discussion of this literature is contained in Chapter 5.
[5] See for example, Abiad and Mody (2005) and Martinez-Diaz (2005).

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also explores the determinants of financial liberalization in SSA. Second, unlike most studies on the political economy of financial liberalization, this study focuses exclusively on liberalization of the banking sector. Thirdly, by focusing on Sub-Saharan Africa's experience with financial sector reforms – a subject that has received little attention from researchers – this study attempts to provide policy makers with tools for future decisions with respect to development policies for SSA.

One of the major contributions of this dissertation is the development of a database containing variables related to financial sector liberalization in SSA. The database identifies dates of policy changes in the financial sector of 30 SSA countries over the period 1973 to 2003. This database developed is unique in several respects. First, to the best of my knowledge, it is the first comprehensive database identifying episodes of banking sector liberalization in SSA countries.[6] Second, its coverage is larger in scope as it covers more countries over a longer period than most existing databases.[7] Third, this database is the only one whose sample is made up of countries from the same region.

Another major contribution of this study is its examination of the effects of financial liberalization on the balance of economic powers and the emergence of new elites in Nigeria. Most studies on financial liberalization have focused on the effects of liberalization on financial sector development and economic growth. The belief that government controls almost always foster rent-seeking and inefficient allocation of resources, while the elevation of market forces checks rent-seeking, enhance competition and improve society's welfare has often made it convenient for researchers to ignore the

[6] Abiad and Mody's database includes only 3 SSA countries – Ghana, South Africa and Zimbabwe.
[7] The database constructed by Abiad and Mody (2005) covers 35 countries drawn from different regions of the world over a 24- year period, giving a total of 840 observations. Total number of observations in my database is 930 inclusive of missing data points.

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unintended consequences of financial liberalization. In addition to analyzing the effects of financial liberalization on the financial sector in Nigeria, this study highlights the impacts of liberalization on the redistribution of economic power and the emergence of a new elite in the country.

A final contribution of this thesis is its incorporation of key informant interviews in Nigeria. These interviews were conducted in the field as a means of supplementing the quantitative and secondary source analysis with the views and suggestions of those in the banking sector as well as some of those involved in the government reform process. Fieldwork in this area is difficult, and brings with it special challenges regarding attribution. It is particularly difficult given that some of the matters of relevance to financial reform involve illicit and corrupt activities, making it difficult to either identify sources or provide independent corroboration. Nonetheless much of the material collected through the interviews reinforced the story emerging from the analysis and it provided valuable insights into the actual reform process.

The rest of this dissertation proceeds as follow: Chapter 2 contains a review of the literature on the determinants of financial sector liberalization. It reviews the internalist and externalist explanations for financial liberalization. While the internalist perspective posits that domestic forces determine the timing and scope of financial liberalization in developing countries, the externalist explanation argues that external forces represented by international financial institutions, and by foreign donor/creditor nations, imposed financial liberalization on developing countries. The chapter also reviews other political and economic factors that could dislodge the status quo and necessitate a country's move from financial repression to financial liberalization.

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Chapter 3 provides empirical evidence on the determinants of financial liberalization in a cross-section of SSA countries. The level of liberalization developed in the database of financial liberalization is the dependent variable and the independent variables include various economic, political, and ideational factors. The independent variables are generated on the basis of the theory and empirical evidence explored in Chapter 2. Results presented in Chapter 3 show that the presence of an IMF program increases the likelihood of financial liberalization in the average country. But the evidence presented in Chapter 3 also supports the "learning hypothesis", which suggests that countries are more likely to implement financial liberalization if a regional leader has implemented financial liberalization.

Chapter 4 is a case study of the determinants of financial liberalization in Nigeria. It provides qualitative evidence on the factors that led the Nigerian government to implement financial liberalization in the mid-1980s. As in Chapter 3, analyses of the determinants of financial liberalization in Nigeria are organized around the external/internal explanations, economic and political factors, and policy learning and ideational shifts. Similar to the evidence presented in Chapter 3, the Nigerian case study shows that the IMF was a significant factor in Nigeria's decision to implement financial sector liberalization. The Nigerian evidence also suggests that the ideas of senior policy makers in Nigeria were important factors that led to financial liberalization in the country. [8]

Chapter 5 presents a review of the literature on the effects of financial liberalization on the financial sector. It reviews theory and empirical evidence on the

[8] Some people might argue that the cross-country evidence and the case study results are not related because of the different underlying assumptions in each case. However, as discussed in Chapter 4, the case study brings an important perspective and makes a significant contribution to this study.

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effects of financial liberalization in developing countries. As a follow up to Chapter 5, Chapter 6 assesses the impacts of financial liberalization on financial sector development in Nigeria. Although the chapter contains quantitative data on these variables, the major focus of analysis is on the qualitative description of changes in Nigeria's banking sector during the period of financial liberalization. Evidence presented in Chapter 6 suggests that financial liberalization increased the scope and not the depth of the financial sector in Nigeria. That is, although financial liberalization led to phenomenal increase in the number of banks and other financial institutions, there was no significant improvement in most measures of financial sector development.

Furthermore, Chapter 6 explores the effect of financial liberalization on the distribution of economic power in Nigeria. It shows that financial liberalization widened the scope for rent seeking, and made it possible for individuals and professionals outside the military/political class to amass enormous financial wealth that would have been impossible during the era of financial repression. The newfound economic power of bank executives has led to their emergence as a new elite in a society characterized by glaring class distinctions. Chapter 7 concludes the study and teases out theoretical and policy implications of the findings.

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Chapter Two

Factors that Influence Financial Sector Reforms: A Literature Review

Researchers often explain a country's domestic policy choice from two distinct perspectives. One perspective is the internalist argument, which posits that internal political, social and economic structures and interests influence domestic policy decisions. The other explanation is the externalist argument, which suggests that domestic policies are dictated by the actions and inactions of external forces, including international financial institutions, and donor and creditor nations. Adherents to the externalist school point to the increasing interdependence amongst nations and argue that this level of interdependence restricts independent domestic policy actions, especially in economically 'backward' countries. However, in many cases there is significant correspondence between the external and internal argument, to the extent that explaining domestic policy choices as driven entirely by either external or internal factors may be problematic.

Within the broad spectrum of internal and external explanations, Abiad and Mody (2005) explore factors that could influence financial liberalization policy in a sample of 35 countries drawn from various regions of the world. The factors explored in Abiad and Mody include: (a) shocks that affect the decision-making power, leading to either reforms or reversals, (b) perceived payoffs, updated through learning, and (c) ideology, and political and economic structure. These factors are processed and transmitted through different mechanisms to the decision- making stage. Upon a review of studies on the political economy of financial liberalization, we identify five clusters of factors that could lead to the adoption of financial sector liberalization in a given country.

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These clusters include: domestic political factors, domestic macro-economic factors, pressures from domestic interests groups, international economic pressures and forces, and learning or ideational shifts. It is pertinent to note that these factors are not mutually exclusive, as two or more factors may be at play in a country at the same time.

2.1 Domestic Political Factors

Proponents of financial liberalization argue that financial repression facilitates rent seeking by political elites who use the instrument of credit controls for selfish accumulation of wealth. On the one hand, autocratic regimes with little or no political checks and balances are seen as favouring financial repression so as to give political office holders exclusive control over the financial sector (Girma and Shortland, 2005). On the other hand, democracies, which are subject to political checks and balances and which rely on popular support in order for incumbents to remain in government are more likely to support financial liberalization.[1]

Using data from 26 countries spanning the period 1973 to 1999, Girma and Shortland (2005) (subsequently referred to as GS), explore the impact of domestic political structure on financial liberalization decision. They show that fully democratic governments are more likely to liberalize than less democratic, but not fully autocratic, regimes. To measure the extent of financial liberalization, GS assign the values of 1, 2, or 3 for fully liberalized, partially liberalized or repressed financial systems respectively. For the banking sector to be considered fully liberalized there should be no controls on interest rates, no directed credit guidelines and deposit in foreign currencies must be permitted in domestic banks.

[1] This argument is based on a negative view of financial repression as a mere instrument of rent seeking. It also implicitly assumes that autocratic regimes are incapable of advancing the public good.

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To measure the domestic political structure (whether democracy or autocracy), they use *polity2* - a combined polity score index obtained from the Polity IV database. *Polity2* captures a regime's institutionalized authority characteristics and is obtained from subtracting *autocracy score* from the *democracy score* of a country. For each country, the Polity IV database contains a democracy score (ranging from 0 to 10) as well as an autocracy score with the same range. The democracy score of a country is based on the openness of the political process in a given country as well as the degree of political accountability in that country. Fully democratic regimes with functional checks and balances take the maximum score of 10. The autocracy score of a country is based on how political leaders are selected (whether the opportunity is open to all or restricted to a select few), as well as the constraints on executive powers. Some countries have mixed authority traits and can have different scores on both measures. The authors note that the *Polity2* variable is a good indicator of the extent to which the people can express their will at the ballot box.

GS report that *Polity2* has a negative effect on banking sector liberalization. However, when *Polity2* is disaggregated into its democracy and autocracy components, a high level of democracy increases the likelihood of banking liberalization. Surprisingly, increasing autocratic regimes (autocracy score of, or close to 10) also has a similar effect as full democracy. The authors note that this result is not puzzling given that fully autocratic regimes have other direct ways of suppressing opposition, such that the indirect means of financial repression is not necessary to oppress the opposition. This result is line with the "political replacement effect" hypothesis advanced by Acemoglu and Robinson (2000). The hypothesis states that if incumbents fear the loss of political

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power following economic or institutional reforms, they will block such reform. However, incumbents that are highly entrenched (as in full autocratic regimes) may not oppose reforms because there is no risk of losing political power.

Another internal political factor explored in GS is the level of political instability and the effect of this variable on the decision to liberalize the financial system. Political instability, which is measured by the "durable" variable from Polity IV, denotes the number of years that have elapsed since a regime change.[2] The durability measure seeks to capture the challenges of governing in an unstable environment that is prone to contending interests sometimes expressed in a violent manner. GS show that the effect of the durability variable is not significantly related to banking sector liberalization. Similarly, Abiad and Mody (2005) confirm that drastic political changes such as coups d'etats do not affect the likelihood of financial reforms.

Using data from 35 countries across several regions from 1973 to 1996, Abiad and Mody (2005) assess the effect of changes in political office holders on the likelihood of financial reforms. They show that the likelihood of reforms increases significantly within an incumbent's first year in office. However, they note, as did Haggard and Webb (1993), that reforms during an incumbent's first year in office could be in one of two directions – a reversal of previous policies or the introduction of new ones. This observation has led to what has been referred to as the "honeymoon hypothesis". New governments desirous of improving its public ratings may introduce financial reforms within the first year in office. However, it is also argued that incumbents who are concerned about re-election may not introduce new policies if voters would feel the cost

[2] Regime changes refer to major changes in the polity such as coups, civil wars or foreign occupation. A regular transfer of political power from one candidate or party to another does not qualify as a regime change for the purpose of defining this variable.

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of such policies in the short-run, while its benefits are only realizable in the very long-term (after the term of the incumbent).

The likelihood of a particular government adopting financial liberalization may also depend on the interests within the population that such a government represents. A right-wing government that is supported by owners of capital and sympathetic to the interest of capital is more likely to adopt policies to benefit domestic capital. Such a government would be well disposed to financial liberalization because owners of capital generally want little or no restriction on how to deploy their capital for the highest return. Quinn and Inclan (1997) identify this phenomenon as the "partisan macro-policy effect" (p.779).

It is pertinent to note that while owners of capital in capital-rich countries are likely to prefer financial liberalization to financial repression, it is not clear that such would be the case for owners of capital in labour-rich countries. In countries where there is scarcity of capital and abundance of labour, owners of capital may resist financial liberalization in order to enjoy abnormal returns on the limited capital available in the country. They will block liberalization as a way to ward off the inflow of capital from foreign countries. The implication is that right-wing governments may not necessarily favour financial liberalization in all cases. If owners of capital have the capacity to influence domestic policy, government disposition to financial reforms may depend on the interest of domestic capital. In their cross-country studies, GS show that the partisan macro-policy effect does not affect the likelihood of financial liberalization.

In general, domestic political structures such as the level of democracy or autocracy, and the stability of the political regime, could have significant effects on

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government decisions regarding financial sector policies. Similarly, the political orientation of an incumbent regime (governments oriented towards the "left", "right" or "center") would likely influence government policy decisions one way or the other. While political orientation may not be particularly relevant in the SSA context because the division between center, left, or right-wing government is not clear in these countries, the level of democracy and autocracy and the extent of political stability are critical factors that could have significant influence on government policy decisions. Therefore, the next chapter will empirically test the significance of these variables (democracy, autocracy, and political stability) on financial liberalization decisions in Sub-Saharan Africa.

2.2 Domestic Macro-economic Factors

Economic factors such as fiscal deficits, rising inflation, and trade openness could affect the likelihood of financial reforms in a given country. If financial repression were designed to enhance economic growth, one would expect policy makers to change the policy direction where repression is not producing the desired growth rate. Financial liberalization could therefore be a policy response to economic difficulties, fiscal imbalance or slow growth. Minushkin (2001) shows that under financial repression, a country with high GDP growth rate is likely to retain entry and exit barriers, as policy makers would not have reason to experiment with new policies when the economy is doing well. Similarly, high spending governments facing fiscal deficits are expected to favour financial repression, because domestic investors usually have limited investment opportunities in repressed financial systems. Where opportunities for international investing are limited (as may be the case under financial repression), domestic investors

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are likely to invest in government debt, despite the government's fiscal ill-health. Government would therefore prefer to keep the financial market closed in order to avoid capital flight.

Using a three-year lagged average of fiscal imbalances as a share of GDP, GS explores the effects of fiscal deficits on the likelihood of financial liberalization. They show that fiscal prudence is associated with a higher probability of financial liberalization. International investors are less likely to invest in bonds issued by governments with large fiscal deficits, and domestic investors would also prefer to invest in non-government instruments if they had the opportunity. This behavior occurs because investors see high fiscal deficits as an indication that a country may not be able to meet its debt payment commitments. Governments with large fiscal deficits are therefore restricted to finance the deficit in the local market.

However, Minushkin (2001) suggests that when a country is borrowing from the IMF and at the same time faced with high inflation and fiscal deficits, opening up the financial sector is a less risky policy stance as such a country may benefit from international capital. Perhaps this is based on the assumption that international investors see a country's participation in an IMF program as a sign of good domestic policy in that country. In this way, IMF programs convey a seal of approval on a country's domestic policy and increase the interest of foreign investors in that country. However, empirical evidence in Bird and Rowlands (2001) does not support the alleged catalytic effect of IMF programs in developing countries. Bird and Rowlands note that mere participation in IMF program does not attract foreign capital inflows into a country. Other political and

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economic factors and the credibility of reforms are important considerations influencing private capital flows.

Another macro-economic factor that may affect the likelihood of financial liberalization is the level of trade openness. Trade openness may induce financial liberalization, as foreign firms with operations in the local market search for ways to facilitate the repatriation of profits to their home countries. Haggard and Maxfield (1996) note that dependence on international trade and finance affect domestic policy decisions regarding the level of financial openness. They measure dependence on trade by the sum of exports and imports as a share of GNP. Foreign savings as a share of capital formation, or total foreign debt as a share of GNP is used as a measure of dependence on international finance.

A high level of interdependence increases the strength of domestic actors with ties to foreign multinationals. These domestic actors are assumed to have the capacity to assert potent pressures on the government to adopt policies conducive to internationalization. Where government does not respond to these pressures, investors may be able to circumvent capital controls using the power of technology and contacts with international business partners (Girma and Shortland, 2005). Minushkin (2001) also confirms the existence of a positive relationship between a high level of foreign trade and financial transactions and financial sector opening. However, Abiad and Mody (2005) did not find a significant relationship between trade openness (measured by the sum of imports and exports relative to GDP) and financial liberalization decisions.

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2.3 Domestic Economic Interests

Interest groups have historically played significant roles in domestic policy choice in several countries. Domestic actors in pursuit of rational self-interest may lobby the government to formulate policies necessary to advance their group's interest. Minushkin (2001) and Martinez-Diaz (2005) both explore the influence of domestic actors on financial reforms. Minushkin notes that a domestic political bargaining process involving the executive, the financial policy making bureaucrats, and the financial sector mainly drives the opening of the financial market. The relative power and interests of these actors affect the timing and direction of financial reforms. Besides the dynamics of power played out among contending interests, executive initiatives generally have a significant effect on the timing of financial liberalization.

GS explores the influence of lobbying from the service sector actors on the financial liberalization decision. They note that the service sector, such as private financial intermediaries, lobby for financial liberalization as a way to improve the sector's independence and performance. For example, during the era of financial repression, government credit controls and interest rate ceilings restricted the ability of bank managers to make independent business decisions. Managers were expected to abide by credit quotas set by the government, or to lend to priority sectors, even when such directives did not make good business sense. In effect, banks may have missed out on profitable investment opportunities that may be available in non-priority sectors. On this basis, it is obvious why bank managers would lobby politicians and policy makers for the introduction of financial liberalization.[3]

[3] However, in order to expect this form of reaction from bank managers, one would need to ascertain whether managers desire the independence as well as the responsibility that flows with it. Mkandawire

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To proxy for the intensity of pressures from the services sector, GS uses "share of value added in the service sector as a percentage of GDP" obtained from the World Development Indicators. The service sector includes not only financial services but also retail, health, education, tourism, transport and other government services. They show that countries with large service sector relative to manufacturing and agriculture are more likely to have liberalized banking system. This result is in line with the fact that agriculture and manufacturing were the traditional "priority sectors", that benefited from government subsidies during the era of repression. The service sector as a whole, which was not usually a priority, would presumably prefer financial liberalization in order to have a level playing field with the agriculture and manufacturing sectors.

In an attempt to explain the failure of development planning in India, Turkey and Brazil, Chibber (2005) argues that the activities of national bourgeoisie led to the demise of development planning, and paved the way for neoliberal policies. According to this view, domestic capital saw development planning not as a means of achieving national development, but as "a process in which public monies were put at their disposal, and at their behest" (p. 233). Consequently, those who were benefiting from financial repression did not buy into the spirit and intent of the industrial policies of that time, but were more concerned with personal wealth accumulation, even as they viewed government subsidies as way of socializing risks, "while leaving private appropriation of profit intact." (p. 233). Through government subsidies and preferential credit, some businesses made abnormal

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(1999) notes that banks in many African countries were mostly state-owned prior to liberalization; and managers were basically government employees who could not conceive of an alternative to financial repression. This view is reinforced by Stasavage (1997) who showed that private banks in the French African countries exhibited little interest in pushing for the independence of the monetary authorities or in the liberalization of the sector. Indeed, in a number of African countries, privately owned commercial banks are recent phenomena. If bank managers were not responsible for the bank's performance nor making key business decisions, such managers may oppose rather than lobby for financial liberalization.

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profits but did not undertake long-term investment in the true spirit of development planning. The search for short-term profits and the avoidance of projects that could have positive externalities on the community made it impossible for countries to realize the aspirations encompassed in the development plans.

According to Chibber, the blame for the end of development planning should not be placed on the IMF or the United States, but on capitalists whose activities led to the economic difficulties. However, Chibber was quick to point out that despite the problems associated with development planning, neo-liberalism has not produced better outcomes. Though the activities of national capital undermined the true intent of development planning, Chibber's analysis fails to show how the anti-development activities of capitalists led to the adoption of financial liberalization. The failure of development planning is not synonymous with the introduction of financial liberalization, as alternative policies could also have been devised to replace development planning.

Like domestic economic factors, lobbying by domestic interest groups is an important factor that could influence government policy decisions. However, the impact of lobbying in the policy process is determined, at least in part, by the strength of the sector or group whose interest is at stake. In the next chapter, I test the significance of domestic economic factors such as GDP growth, economic recession, and balance of foreign reserves. I also explore the impact of domestic lobbying as represented by the value added by the service sector as a percentage of GDP, on the probability of financial liberalization in Sub-Saharan Africa.

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2.4 International Economic/Political Pressures

Besides domestic political and economic structures and interests, international pressures flowing through different channels could have a significant impact on domestic policy decisions. The impact of international pressures usually has more weight in countries that depend heavily on foreign capital, including debt, aid and foreign investments.

Another source of international pressure that could affect domestic policy choice in developing countries is pressures from international financial institutions, especially the IMF and the World Bank. In analyzing the influence of external forces on domestic policy choice in African countries, it easy to identify the influence of the World Bank, the IMF and other creditor or donor nations on major development policies. Through various conditionalities attached to IMF programs, a country may implement policies that are not in line with the wishes of domestic actors. However, this does not imply that the World Bank or the IMF simply determine economic policies unilaterally in developing countries. Abiad and Mody (2005) show that countries with IMF programs are more likely to liberalize than if there were no IMF programs. However, they note that the presence of IMF program has a strong influence only under conditions of relatively high repression, and a declining effect thereafter.

The result in Abiad and Mody (2005) is contrary to those of GS who did not find evidence that IMF programs are associated with higher likelihood for financial liberalization. Indeed, they show that countries with IMF programs are less likely to be fully liberalized. GS explains this finding from the perspective that countries with severe economic problems are the ones more likely to have IMF programs, and for such

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countries, financial liberalization may not be a good option. After limiting the test to developing countries only, GS find results consistent with those of Abiad and Mody.[4] However, in a case study of Brazil and Mexico, Martinez-Diaz (2005) found that pressures from international financial institutions have "little explanatory power regarding the timing and style of liberalization" (p. 5) in the two countries.

Based on a case study of Indonesia, Chile, Mexico, and South Korea, Haggard and Maxfield (HM, 1996) explore factors that could explain capital account liberalization in these countries. The authors identify balance of payment crises as a leading cause of capital account liberalization. Annual percentage change in a country's foreign reserves is used as an approximate measure of balance of payment situation. A significant deterioration in foreign reserves from one year to another is considered an indicator of a balance of payment problem. HM notes that this quantitative measure should be supplemented by other qualitative indices because a country may deliberately alter its current account position. Consequently, they use qualitative measures such as a country's "stock of credibility with creditors and investors, the extent of international liquidity, and the capacity to adjust through an expansion of exports" (HM, p. 43) alongside the quantitative measures. Using a combination of these qualitative and quantitative indicators, HM identify 11 periods of balance of payment crises in Indonesia, Mexico, Chile and South Korea.

To proxy for the timing of financial liberalization, HM used data from the IMF annual reports on exchange arrangements and restrictions to devise a measure for the level of financial openness in each of the countries during the 1970 – 1990 periods. The

[4] The inconsistency in the results reported in GS underscores some of the problems with using a sample of countries at widely different levels of political and economic development.

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measure of financial openness is based on three indicators: the international operations of domestic and foreign commercial banks, payment for financial services and repatriation of capital, portfolio investment and borrowing, and direct investment. Values assigned to these indicators range from 0 (the least open) to 3 (very open). A value of 12 (3 in each indicator) means a high degree of financial openness, and 0 means complete lack of openness. HM identified 11 instances of a significant change in the financial market openness in the countries under study; of these 11 episodes, 8 were moves towards greater openness, while 3 were changes towards a tightening of controls. Of the 8 changes towards more liberalization, HM noted that 7 originated from a balance of payment crisis. However, Rowlands (1999) found no evidence that balance of payment crises increased the likelihood of financial liberalization. Focusing on capital account liberalization, Rowlands suggests that liberalization is more likely to occur when a country is not facing current account crisis, or when there is no excessive dependence on foreign trade.

Although it may appear counter-intuitive for a country to open its capital account during periods of balance of payment crises, such openness may be explained by the signaling hypothesis: governments facing balance of payment crisis would liberalize as a way of earning credibility in the eyes of foreign creditors and investors. Foreign investors and creditors see financial openness as an indication of government's favourable disposition to free flow of capital. Because investors want the flexibility to repatriate funds easily in the event of crises, they are more likely to invest in a country with the least amount of restrictions than in a country with more restrictions. However, relaxing capital account controls during balance of payment crises is somehow contrary to

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conventional wisdom, which would recommend more controls during crises as a way to avoid further capital flight. HM suggests that the cost of not liberalizing in the face of crisis will be low under these conditions: where the dependence on foreign capital has been low, where there is abundant international liquidity, and "where the government is confident in its ability to generate foreign exchange through exports" (p. 43).

International political and economic factors have always influenced domestic policy choices. However, recent trends in bi-lateral and multilateral relationships, technological advancement, globalization, and the increase in international trade have increased the importance of international pressures in national policy decisions. International pressures tend to have more significant effect in poor nations than in rich and industrialized countries. This is because poor nations tend to place significant weight on foreign aid, loans, and policy and technical assistance in advancing their national aspirations. One would therefore expect that domestic policies in Sub-Saharan African countries would be determined, at least in part, by international pressures. I test this hypothesis in the next chapter by exploring the impacts of IMF program, trade openness, and balance of payment crises on the likelihood of financial liberalization in Sub-Saharan Africa.

2.5 Learning and Ideational Shifts

Policy learning and ideational shifts among senior policy makers may affect the likelihood of financial liberalization in a given country. In the last few decades, neoliberal ideas have permeated countries in different parts of the world and at different levels of political and economic development. The activities of international financial institutions and those of the United States government have facilitated the spread of

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neoliberal ideas across the globe (Stallings, 1992). Martinez-Diaz (2005) argues that the changing beliefs and preferences of policy makers were responsible for financial liberalization in Brazil and Mexico. Senior policy makers who are exposed to neoliberal teachings either through exposure to the World Bank and IMF, or through graduate studies in the United States, may become sympathetic to the idea of market reforms, thereby leading them to support financial liberalization in their countries.[5]

This form of ideational shift is sometimes categorized as part of the external influence on domestic policy choices. Mkandawire (1999) argues that structural adjustment in Africa could not simply be a result of policy learning by African policy makers, because "the fact that the policies are being adopted simultaneously throughout the continent suggests the operation of processes that almost ineluctably drive all economies towards an identical set of solutions irrespective of the pace of intellectual metamorphosis among policy makers" (p. 336). This is valid if one can show that all policy makers are undergoing the same intellectual and ideational rebirth simultaneously, otherwise there is reason to suspect the influence of external forces in the learning process and ideational shifts.

Related to ideational shifts is policy learning or emulation. Under policy emulation, policy makers in one country may copy a successful policy in another country (Hoberg, Banting, and Simeon; 2002). This form of policy convergence is very likely to occur among countries in the same region or similar economic or political clusters. According to Abiad and Mody (2005), successful liberalization in a major country within a region (regional leader) has a significant positive effect on the probability of reforms in

[5] For example, it is reported in Babb (2001) that the Salinas administration in Mexico was made up of a very cohesive group of foreign-trained technocrats who believed in the efficiency-enhancing properties of market reforms.

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other countries in the region, and a similar result was obtained in GS where it is reasoned that countries tend to follow the example of regional or group leaders.[6]

Commenting on the ideas and beliefs of senior policy makers, Bangura (1994) suggests that if domestic policy makers in Africa had switched preferences from government controls to liberalization, such a change of mind was in deference to international financial institutions (IFIs). According to Bangura, the IFIs actively supported and helped to strengthen the position of local officials who were considered sympathetic to the policies prescribed by these institutions.

Lewis and Stein (1997) explore the political economy of financial liberalization in Nigeria, and noted that the IFI and senior officials of the Ministry of Finance were the significant actors that pushed for the adoption of financial liberalization. According to these authors, "the central pressures for deregulation emanated from the IFIs and leading officials in the Ministry of Finance, while the departments within the Central Bank of Nigeria (CBN) and the finance ministry grappled with oversight of the banking industry" (p. 10). Consistent with the views expressed in Bangura (1994), Lewis and Stein suggest that officials of the Ministry of Finance and those of the Central Bank of Nigeria supported financial liberalization in adherence to IFIs conditionalities so as to "secure debt relief and access to new capital" (p. 10). What is not clear in Lewis and Stein's analysis is whether the Nigerian officials genuinely believed in the hypothesized benefits of financial liberalization and used the IFIs to strengthen their beliefs, or whether they supported the policy only because they needed to satisfy the IFIs in order to obtain debt relief and new capital or saw that they could simply increase their personal wealth

[6] GS notes that this phenomenon could be due to the learning effect or for the sake of competition. They explore this hypothesis using countries in the G7 Europe, South America and Asia.

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In the next chapter, I test for the impacts of policy learning on the probability of financial liberalization in SSA. In addition, using a case study of Nigeria, I explore the effects of policy makers' ideas and beliefs in the financial liberalization decision. The case study is presented in Chapter 4.

Conclusion

There are many potential explanations for the timing of financial liberalization. Based on the studies reviewed, domestic political structure is shown as one important variable that affects the likelihood of liberalization. Increasing democracy is associated with the increasing likelihood of liberalization, while autocratic regimes would prefer to keep the financial sector repressed. However, it is also shown that complete democracies and absolute autocracies have similar impact on the likelihood of financial liberalization – such governments are more likely to liberalize. Learning and ideational shifts among senior policy makers regarding the causal relationship between financial openness and economic development are also shown to have a strong impact on the likelihood of financial liberalization.

There is no consensus on the impacts of fiscal deficits and balance of payment crises on the timing of financial liberalization. Similarly, there is no consensus on the effect of external political pressures, including the presence of IMF/World Bank programs.[7] There is also a lack of consensus on the approximate effect of domestic economic interests (including domestic bank managers) and the level of trade openness on the liberalization decision.

[7] However, there appears to be a consensus that changes in causal beliefs among senior government officials has a significant impact on the likelihood of financial liberalization. These ideational shifts may be as a result exposure to the ideology of the World Bank and IMF or indoctrination through neoliberal training especially in US institutions.

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It should be noted that many of the empirical studies examined above used cross-country data drawn from countries at widely different levels of economic and political development.[8] In addition, the case studies focus on the experiences of countries in Asia and the Americas. To the best of our knowledge, there has been no rigorous enquiry into the timing of financial liberalization in SSA countries as a group, although these countries opened their domestic financial markets before or simultaneously with Asian and Latin American countries.

Furthermore, almost all the studies focus entirely on capital account opening or treated both capital account opening and domestic financial market liberalization as one and the same event[9] (a summary of the major empirical studies reviewed in this chapter is presented in Table 2.2). This approach makes it difficult to generalize findings from these studies to African countries where the banking sector remains the principal focus of financial liberalization.[10]

This dissertation seeks to close some of the gaps in the literature by (a) conducting a cross-country evaluation of the determinants of banking sector liberalization in Sub-Saharan Africa (b) presenting a case study of financial liberalization in Nigeria. Nigeria is chosen because it is one of the major economies in Sub-Saharan Africa and it is included in the International Financial Corporation's database of emerging markets; (c) empirically examining the forces that explain banking sector liberalization, without having to aggregate banking sector and capital account opening as has been the practice

[8] Both Girma and Shortland (2005) and Abiad and Mody (2005) use panel data from countries at the extremes of financial development and financial underdevelopment.
[9] Notable exceptions are Girma and Shortland (2005) and Martinez-Diaz (2005).
[10] Many SSA countries have not traditionally been large recipients of foreign capital, therefore, experimenting with capital account, as a way to attract foreign investment has not been the focus of these countries.

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with most studies in the literature; (d) testing existing hypotheses on countries other than the ones on which the hypothesis were developed; and (e) exploring the connections between the timing of financial liberalization and its impacts.[11] Along these lines, the next chapter will empirically test the impacts of the following factors identified in the preceding review:

Table 2.1 – Table of Independent Variables

Economic Variables	**Political Variables**	**Others**
GDP Growth	Level of Democracy	Domestic lobbying
Foreign Reserves	Level of Autocracy	IMF Program
LIBOR	Polity2	Policy Learning
Trade Openness	Political Stability	
Recession		
Balance of Payment Crisis		
High Inflation		

[11] This point is examined in the second part of the dissertation

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Table 2.2 - Summary of major empirical findings on factors leading to financial liberalization

Author/Year	Sample/period	Dependent variable	Independent variable	Results
Abiadand Mody (2005)	35countries drawnfrom various regions (1973-1996)	Financial liberalization measured by six policy dimensions: -Credit controls -Interest rate controls -Entry barriers -Regulations and security market -Privatization in the financial sector -Restriction on international financial transactions Each measure is assigned the value of 0 for full repression, 1 for partial repression, 2 for largely liberalized and 3 for fully liberalized financial sector	a) Incumbent's first year in office b) Drastic political change, e.g. coup d'etat c) The presence of IMF program in a country d) Balance of payment crises e) Trade openness	Increases the likelihood of reforms Financial reforms unaffected Increases the likelihood of reform; with the effect being strongest in a country with highly repressed financial system Positively related to liberalization No relationship
Girma and Shortland (2005)	28 countries drawn from Asia, Europe, Latin America and North America (1973 to 1999)	Banking liberalization, stock market liberalization and capital account liberalization. Each variable takes the value of 1 for fully liberalized, 2 for partially liberalized, and 3 for	a) Domestic politics (democracy vs. autocracy) b) Political instability	Positively related to banking liberalization – full democracy and absolute autocracy are is more closely associated with liberalization Not associated with banking liberalization, but associated with capital account

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		repressed. (For a banking system to be fully liberalized, there must be no controls on interest rates, no credit guidelines, and deposits in foreign currency must be permitted)		restrictions
			c) The presence of IMF program	Does not affect banking liberalization in the large sample, but positive and significant for a sub-sample of developing countries
			e) The size of the service sector	Countries with large service sectors are more likely to liberalize
			d) Fiscal prudence	Increases the likelihood of liberalization;
			e) Competition and learning effects	Liberalization by a regional leader affects the likelihood of liberalization in other countries within the region (in the same direction as the regional leader)
Martinez-Diaz (2005)	Case study of Mexico and Brazil	Banking sector liberalization	a) External political pressure (IMF/World Bank)	Have little or no explanatory power on the timing of financial liberalization in these countries
			b) Ideational shifts and causal beliefs among senior policy makers	A major factor leading to the liberalization decision
			c) Pressures from domestic actors	Little or no explanatory power – pressures from the

				banking sector did not significantly affect the timing of liberalization.
Haggard and Maxfield (1996)	Case study of Chile, Indonesia, Mexico, and South Korea (1970 –1990)	The level of financial sector openness based on IMF's annual report on exchange arrangements and restrictions (focus is on capital account liberalization)	a) Balance of payment crises b) Level of trade openness (defined as the ratio of foreign to domestic transactions	Crisis increases the likelihood of liberalization High export + import relative to GNP increases the likelihood of liberalization

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Chapter 3

Determinants of Financial Liberalization in Sub-Saharan Africa

3.1 Introduction

There has been a general trend towards financial sector liberalization across different countries in every region of the world. From Asia to Africa, and from Europe to the Americas, financial liberalization has been an important component of domestic economic policies in the past three decades. While several studies have examined the impact of financial liberalization on economic growth in different countries, very few studies have explored the factors influencing the likelihood of financial liberalization. This chapter uses a newly constructed database to identify the determinants of financial liberalization in Sub-Saharan African (SSA) countries.

The literature on the political economy of financial liberalization in developing countries has focused mostly on explaining capital account liberalization in Asia and Latin America.[1] Recently, Abiad and Mody (2005) used cross-country data to explore the determinants of financial liberalization, from 1975 to 1996, in a sample of 35 countries drawn from different parts of the world. Of the 35 countries in Abiad and Mody's sample, only Ghana, South Africa and Zimbabwe are drawn from SSA. Similarly, Girma and Shortland (2005) explored the causes of financial liberalization in a sample of 25 countries. However, their sample did not include any African country.

Although researchers have generally paid little attention to financial sector policies in SSA countries, the financial sectors in these countries have undergone similar reforms as those of Asian and Latin American countries. Banking reforms in SSA have

[1] See for example, Haggard and Maxfield (1996) and Minushkin (2001)

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generally entailed moving from a regime of extensive government controls to a market-based system, where market forces determine deposit and lending rates, as well as other financial sector variables.

From the literature summarized in the previous chapter, we can identify different factors that may lead to financial liberalization in different countries. First, international pressures transmitted through official lenders such as the IMF or the World Bank, and private sources of capital such as banks and private investors, may necessitate financial sector reforms in previously repressed financial systems. Second, financial liberalization may be triggered by economic crisis such as recession, balance of payment crisis or episodes of high inflation. The level of international trade in a given country may also affect the likelihood of financial liberalization in that country. Third, political structures or regime characteristics may have significant effects on the likelihood of financial liberalization in a country. Fourth, regional learning, where one country emulates existing policies in other countries within the region, may lead to financial liberalization by revealing information that causes reassessment of the costs and benefits of current financial sector policies. Regional learning may also be reinforced by the need to compete for international capital (Simons and Elkins, 2004 and Abiad and Mody, 2005). In this chapter, I empirically examine the effects of these and other variables summarized in Table 2.1 of the previous chapter, on the probability of financial liberalization in SSA countries.

The rest of this chapter proceeds as follows: Section 2 describes the database of financial liberalization in SSA and comments on the methodology for this study. In Section 3, I present the empirical results and provide concluding remarks in Section 4.

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3.2 Data and Methodology

Dependent Variable

I construct a new database of financial liberalization in 30 SSA countries over the 31-year period from 1973 to 2003. In constructing this database, I follow the approach in Kaminsky and Schmukler (2003), subsequently referred to as KS. The KS dataset records the extent to which a country's financial sector is liberalized or repressed. It includes data on reforms in the banking sector, stock market and capital account of 28 countries drawn from Asia, Europe and the Americas for the period 1973 to 1999. KS index financial liberalization as 1, 2, and 3 to indicate full liberalization, partial liberalization, and no liberalization (financial repression) respectively, in each of domestic banking sector, stock market, and capital accounts in each year.

The database used in this study focuses on reforms in the domestic banking sector of SSA countries. I assign 0, 1, and 2 to indicate "no liberalization", "partial liberalization", and "full liberalization" respectively. Following the approach in KS, I define the levels of liberalization according to the following criteria.

- In order to qualify for "full liberalization", there must be no government controls over lending and deposit rates, no credit allocation guidelines for banks and no subsidized credit to any sector of the economy. Ownership of banks by private investors is likely permitted.
- For "partial liberalization", there are controls on either deposit or lending rates (ceilings or floors); and there might be controls in the allocation of credit (subsidies to certain sectors or certain credit allocation guidelines). Ownership of banks by private investors is likely not permitted. In summary, there is partial

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liberalization when at least one of deposit or lending rates, or bank lending to the private sector is entirely determined by market forces.

- For "no liberalization" (full repression), there are controls in deposit and lending rates (ceilings and floors); and there are controls over bank lending (subsidies to certain sectors or some credit allocation guidelines). Ownership of banks by private investors may not be permitted.

In order to identify dates of policy change in each country in the database, I follow the approach in Abiad and Mody (2005). The approach involves references to publications on financial sector reforms in countries contained in the sample. To this end, I draw on several sources, most notably, IMF Occasional Paper 169 - *Financial Sector Development in Sub-Saharan African Countries* (IMF, 1998). This publication chronicles important policy changes in the financial sector of Sub-Saharan African countries from the 1960s to late 1990s. It provides comprehensive information on changes in government policies affecting the financial sector. These include, but are not limited to, changes in interest rate regime, changes in monetary policy, and guidelines on equity participation in banks.

In addition to IMF Occasional Paper 169, I draw on information from other publications, which have attempted in varying degrees to measure the extent of financial liberalization in different countries. In this category are the works of Galbis (1995), Brownbridge and Harvey (1998), Williamson and Mahar (1998), Banderia, Caprio, Honohan, and Schiantarelli (2000), Caprio, Honohan, and Stiglitz (2001), Reinhart and Tokatlidis (2003), and Abiad and Mody (2005). Information from these sources is supplemented by references to central bank websites where one exists, IMF country

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reports, as well as Internet searches[2]. In reviewing information from these sources, I paid particular attention to identified dates of policy change in the banking sector. In each case, I crosscheck information obtained from one source with what is contained in other sources.

Despite the valuable resources provided by the publications cited above, it was impossible to generate data on some countries. There was virtually no information on the financial sector of Burundi, Djibouti, Eritrea, Guinea, Guinea Bissau, Liberia, Mauritania, Rwanda, Sierra Leone, Somalia, and Sudan. Since it was impossible to generate data on these countries, they were not included in the database. Therefore, the final sample is made up of 30 countries drawn from the SSA region. Although dropping 11 countries might affect the extent to which one would generalize the results, a sample of 30 out of 41 countries still represents a fair number. Furthermore, in some cases, it was difficult to categorize a country as either "fully liberalized", "partially liberalized" or "fully repressed" in a given year. This was the case in years when there were both controls and deregulation.

In determining a country's liberalization status in a given year, I focused on the year in which the policy change occurred irrespective of the month in which that change occurred. An alternative approach would have been to consider the month in which the change occurred, so that changes occurring towards the end of the year are treated as if the change occurred in the following year. However, I adopted the former approach in order to ensure uniformity across the sample, because majority of the sources did not mention the month in which the policy change occurred, but only indicated the year. Also, in some cases, there was conflicting information on dates of policy change from

[2] See The Privatization Link at http://www.privatizationlink.com/ (last accessed on August 05, 2006)

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different sources. Where there is such conflicting information, I have placed more weight on data from the IMF. This approach is informed by the assumption that the IMF is likely to have more reliable data on the financial sector of different countries given its official involvement with these countries.

Additionally, in some cases, there is ambiguity regarding the liberalization status of a country. For example, there were instances where the government did not specify borrowing or savings rates. However, the banks were expected to maintain a specified spread (margin) between lending and savings rates. This form of interest rate regime would appear to be "less than deregulation" because banks do not have the freedom to determine whether to charge the highest possible interest rates on loans and to pay the lowest rate on deposits. In situations like this, the criteria specified above remained the basis for identifying a country's liberalization status. In effect, partial liberalization is deemed to have occurred where there is control over at least one of lending or savings rate.

The database, which is provided as Appendix 1, shows there are 32 missing data points out of a total of 930. Furthermore, 431 or 48% of the observations had value of 0 (full repression), 235 observations or 26.17% had a value of 1 (partial repression), and 232 observations or 25.83% had a value of 2 (full liberalization).

Recent studies have attempted to construct indices of financial liberalization by identifying periods of financial reforms in different countries. For example, Banderia, *et al* (2000) constructed an index of financial liberalization as 1 or 0. This measure identifies financial reforms as binary variables with no reference to the extent of reforms. Their database covers a sample of 8 countries (Chile, Ghana, Indonesia, Korea, Malaysia,

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Mexico, Turkey, and Zimbabwe). The database constructed by Abiad and Mody (2005), and Kaminsky and Schmukler (2003) is closer in scope to the database used in this study. Neither Abiad and Mody nor Kaminsky and Schmukler treat financial reforms as "either" liberalization "or" no liberalization, but instead categorize financial liberalization according to the extent of liberalization.

The database used in this study is unique in several respects. First, to the best of my knowledge, it is the most comprehensive database identifying episodes of banking sector liberalization in SSA countries. Second, its coverage is larger in scope as it covers more countries over a longer period than most existing databases.[3] Third, this database is the only one whose sample is made up of countries from the same region. Therefore, it provides a fairly comprehensive picture of trends in financial sector policies of the region. Finally, the database used in this study focuses entirely on liberalization of the domestic banking sector.

Despite their distinctive features, most existing databases show similar patterns of financial sector reforms across the world during the past three decades. A review of the SSA database leads to several important conclusions. First, there has been a steady move towards financial liberalization in many SSA countries beginning in the early 1980s.[4] Second, most countries in the sample liberalized gradually, moving from full repression to partial liberalization, and eventually to full liberalization. Third, instances of policy reversals after initial liberalization were few, occurring only in Nigeria and Zambia. Finally, similar to the result in Abiad and Mody (2005), countries in the same region

[3] The database constructed by Abiad and Mody (2005) covers 35 countries over a 24- year period, giving a total of 840 observations. Total number of observations in my database is 930 inclusive of missing data points.

[4] An important exception is South Africa, which had partially liberalized financial sectors prior to 1980.

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(Southern, Western, Central, Eastern regions of Africa) tend to liberalize at about the same time, thus suggesting very strongly the presence of policy learning or competition within regions.

Independent Variables

The independent variables used in this analysis are derived from the literature review presented in the previous chapter and summarized in Table 2.1. The first set of independent variables operationalizes the influence of domestic political regimes on the propensity to pursue financial liberalization. Along these lines, I use the *democracy score*, *autocracy score*, and *durable* to proxy for political structure. The *democracy score* of a country ranges from 0 to 10 and is based on the openness of the political process, as well as the level of checks and balances on the power of the executive. Similarly, the *autocracy score* of a country ranges from 0 to 10 and is based on the process of selecting political leaders. Higher scores indicate higher levels of democracy or autocracy as the case may be. Depending on the political process, a country may have intermediate scores on both the democracy and the autocracy scores. Subtracting the autocracy score of a country from its democracy score yields the *polity2* variable (Marshal, Jaggers, and Gurr; 2005). *Polity2* is designed to capture a regime's authority characteristics, with higher scores indicating higher degrees of openness and democracy and vice versa. As shown in the previous chapter, fully democratic regimes are more likely to favour financial liberalization than less democratic regimes.

Durable measures the number of years that have elapsed since a regime change occurred in a country.[5] It is designed to capture the effects of governing in a stable or

[5] Regime change refers to major interruptions in the polity such as coups, civil wars or foreign occupations. Simple transfer of executive power from one political party to another is not considered a regime change.

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unstable environment. In a country with frequent regime changes, a government is likely to retain controls over the financial sector in order to maintain effective control of the polity. On the other hand, stable regimes with stable political institutions are more likely to adopt financial liberalization because liberalization may not pose a threat to the political power of the incumbent executive. The democracy score, autocracy score, durable, and *polity2* variables are obtained from the Polity IV Database (Marshal, Jaggers, and Gurr; 2005).[6]

To explore the effects of domestic economic factors on the decision to liberalize, I include the annual GDP growth rate, balance of foreign reserves, and the level of exports and imports in relation to GDP in the empirical tests. *GDPGROWTH* is the annual GDP growth rate as obtained from the World Development Indicators (WDI). Under financial repression, a country with high GDP growth rate is likely to retain entry and exit barriers, as policy makers would not want to experiment with a new financial sector policy when the economy is doing well. Therefore, it is expected that *GDPGROWTH* would be inversely related to the likelihood of financial liberalization.

Another economic factor that may affect the likelihood of financial liberalization is a country's balance of foreign reserves (*RESERVES*). With a high value of *RESERVES*, a country may be less prone to the external pressures that usually emanate from owners of foreign capital. As with high *GDPGROWTH*, high foreign reserves may be a sign of sound economic policy. Where a country is able to maintain high GDP growth rate and a healthy balance of foreign reserves, policy makers are likely to retain the existing

[6] The Polity IV database contains information on political regimes of several countries from the 1800s and is updated regularly. (http://www.cidcm.umd.edu/inscr/polity; last accessed on August 5, 2006)

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economic policies. Therefore, all things being equal, *RESERVES* should be inversely related to the likelihood of financial liberalization.

A country's level of trade openness is another macro-economic factor that may affect the likelihood of financial liberalization. Trade openness may induce financial liberalization as foreign firms with operations in the local market search for ways to facilitate the repatriation of profits to their home countries. To measure the extent of trade openness, I use the sum of imports and exports as a percentage of GDP.[7] A high level of *OPENNESS* indicates that foreign businesses and capital have significant influence on the domestic economy. Such external influence would strengthen the position of domestic actors pushing for financial liberalization. *OPENNESS* is expected to be positively associated with the likelihood of financial liberalization.

To proxy for the extent of pressure from domestic capital, I use the value added from the service sector as a percentage of GDP (*VALUEADD*). Given that agriculture and manufacturing sectors were the traditional *priority sectors* benefiting from preferential loans, it is expected that the service sector may push for financial liberalization in a bid to level the playing filed with the other sectors. The relative strength of the service sector is measured by its contribution to GDP.[8] As demonstrated in Girma and Shortland (2005), high *VALUEADD* is expected to increase the likelihood of financial liberalization.

To capture the effect of international economic forces, I use the real London Inter-bank Offer Rate (*LIBOR*) to proxy for world interest rates. Countries may prefer to tighten controls during a regime of high world interest rates as a way to avoid capital flight. Given two investment opportunities yielding similar returns, investors would

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[7] Also used in Haggard and Maxfield (1996), Abiad and Mody (2005), and Girma and Shortland (2005)
[8] The service sector includes the banking sector as well.

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prefer to invest in countries with lower risk. High real *LIBOR* rates may make it attractive for domestic investors to take their capital to more stable countries. Governments may react to this by restricting the movement of capital, and this policy would have an impact on the domestic banking sector as well. Similarly, a poor country may see little value in liberalizing as a means of attracting capital if it is both more costly, and if they consider themselves as being in a relatively weaker position to attract scarce funds. Therefore, *LIBOR* is expected to be negatively associated with the likelihood of financial liberalization.

In order to test the significance of IMF conditionalities on the financial liberalization decision of SSA countries, I include IMF programs in the model. IMF programs available to developing countries include Stand-By Arrangements (SBA), Extended Fund Facility (EFF), Structural Adjustment Facility and the Enhanced Structural Adjustment Facility (SAF and ESAF), which have been renamed as the Poverty Reduction and Growth Facility (PRGF). Disbursement of funds under these facilities is usually tied to a set of conditionalities that the borrowing government must abide by. Such conditionalities often included financial sector reforms in countries where there is financial repression. I review the IMF's Annual Reports to identify periods during which each country in the sample had an IMF facility. I create a dummy variable, which takes the value of 1 when a country has an IMF facility and 0 otherwise. Given that IMF conditionalities often include the requirement for financial liberalization, it is expected that the presence of an IMF program in a country would increase the likelihood of financial liberalization in that country.

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As noted in the previous chapter, recent empirical evidence points to the significance of policy learning in domestic policy choice, especially among countries in the same region. This regional learning effect is predicated on similarities in economic, political, and social spheres existing among neighboring nations. Such similarities may lead to common challenges, making the experience of one country relevant in the policy decisions of other countries. As Fernandez and Rodrik (1991) note, uncertainty about the outcome of reforms can create a bias towards the status quo. However, the reform experience of neighbors would help policy makers in reaching a decision. Similarly, Simmons and Elkins (2004) note that competition for international capital could lead neighboring countries towards similar economic policies. This is more so where such policies are deemed to be conducive to foreign investment. Along this line, it is expected that financial liberalization by regional leaders would increase the likelihood of liberalization in other countries within the region.

I create a dummy variable *LEADERLIB,* which takes the value of 1 if a big country in the region, has undertaken financial liberalization and 0 otherwise. To construct *LEADERLIB,* I categorize SSA into South, West, East and Central regions. South Africa, Nigeria, Kenya and Democratic Republic of Congo respectively, are used as regional leaders. *LEADERLIB* takes the value of 1 for a country in a region in a given year, if the regional leader has undertaken financial liberalization in that year. For example, the value of *LEADERLIB* would be 1 for Ghana in year *t*, if Nigeria has implemented financial liberalization in that year.

In addition to the benchmark variables discussed above, economic shocks such as recession, balance of payment crisis or high inflation may dislodge the status quo and

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necessitate policy reforms. As Krueger (1993) noted, "most reforms seem to take place in one of two circumstances: either a new government comes to power or a perceived economic crisis prompts action" (p.124). To test the significance of economic crisis on the probability of financial liberalization, I construct dummy variables for economic recession (*RECESSION*), balance of payment of crisis (*BOPCRISIS*), and high inflation (*HINFLAT*). *RECESSION* is a dummy variable that takes the value of 1 when there is a negative annual GDP growth and 0 otherwise. *BOPCRISIS* is a dummy variable that takes the value of 1 when there is a large percentage fall in foreign reserves (more than 10% fall in reserves from one year to another), and *HINFLAT* takes the value of 1 when annual inflation rate is at least 50% and 0 otherwise.[9]

Furthermore, I construct dummy variables meant to reflect the structure of the economy and the level of political stability in the country. *HIGHSERVSECTOR* is a dummy variable that takes the value of 1 when the service sector contributes at least 60% of the GDP and 0 otherwise. Although 60% may be seen as an arbitrary number, it is assumed that any sector that accounts for more than half of a country's GDP could have enough clout to influence policy decisions. I define a measure of political stability as *STABILITY. STABILITY* takes the value of 1 when a country has been under a stable regime (without regime change) for at least 20 years. As mentioned previously, regular hand over of power from one political party to another, or from one head of government to another does not constitute a regime change. The *STABILITY* dummy is designed to capture the effects of governing in stable or unstable environment. It is assumed that any SSA country that has maintained a stable regime for 20 years or more should rightly be considered stable given the spate of conflict and political problems in the region.

[9] Abiad and Mody (2005) use similar definitions for recession and high inflation.

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One problem I encountered assembling the data used in this study is that of missing observations. There were missing observations in some of the countries in some years. Missing observations were identified with a "period", instead of zero when the data was fed into the econometric package, STATA. Because STATA treats "periods" as missing observations, they are not used in the estimation procedures. Where the missing observations were severe, I dropped the variable entirely and used an alternative variable. For example, there was little data on current account balance in a number of countries. Consequently, I used the balance of foreign reserves in constructing balance of payment position. It is also pertinent to note that some of the data used in the study may not be reliable given the environment from which they were generated. However, given that the data have been drawn from World Bank's *World Development Indicators*, it is hard to think of other known sources of more reliable data on SSA countries. Despite these challenges, it is believed that results presented in this study present a fair account of the subject under study.

Methodology

In order to ascertain the factors affecting the likelihood of financial liberalization in the sample, I use the ordered probit model. The ordered probit is used for the analysis of categorical dependent variables when such variables follow a natural ordering. The dependent variable used in this study captures the extent of financial liberalization (full liberalization, partial liberalization, or full repression). As indicated in the database of financial liberalization (see appendix to this chapter), I index the three states of financial sector policy by the numerical values 0, 1, 2 to indicate "no liberalization" (full repression), "partial liberalization", and "full liberalization" respectively. Ordinary

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regression techniques would have been unsuitable for this exercise because the differences in the values of the dependent variable denote only differences in ranking and not meaningful quantitative differences.

In an ordered probit model, the dependent variable Y (in this case *LIBRANK,* which is a measure of the extent of liberalization), is a categorization of a continuous, but unobserved variable Y*. If Y* could be observed directly, then standard regression methods would have been appropriate. However, given that Y is used as a proxy for Y*, the relationship between the categories of Y and the values of Y* is given as follows:

$Y = 0 \quad \text{if } 0 < Y^* \leq \mu_1$

$Y = 1 \quad \text{if } \mu_1 < Y^* \leq \mu_2$

$Y = 2 \quad \text{if } \mu_2 < Y^* \leq \mu_3$

Where, the μs are unknown "threshold" parameters to be estimated along with the coefficients of the independent variables. In an ordered probit estimate, a constant term is not included, as a shift in the intercept cannot be distinguished from a shift in the "threshold". In this case, to be specific, the dependent variable is coded "0" if the country did not alter its financial regulatory structure in a significant manner. A value of "1" is assigned if the country moved from a fully repressed to a partially liberalized regulatory structure for its financial sector. Finally, the dependent variable is coded as 2 if the country moved from a fully repressed or a partially liberalized to fully liberalized financial system. In other words, the degree of liberalization is identified as being the highest for those cases where the final regime is fully liberalized.

The study uses data from 30 SSA countries across the 1973 to 2003 periods. In a pooled time series cross-section data such as this, estimated residuals may be correlated

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across countries and/or across time. When the residuals are correlated across observations, estimated standard errors can be biased and either overestimate or underestimate the true variability of the coefficient estimates. This makes any statistical inference from the estimation suspect. To correct for the possibility of correlation in the residuals, I compute robust standard errors using the Rogers (1993) method. The Rogers method computes robust standard errors adjusted to account for possible correlation within a cluster. As shown in Petersen (2005), the Rogers standard error is robust to different specifications and produces correctly sized confidence intervals in the presence of country or time effects. Given that the precise form of correlations in the residual may be unknown, estimations that are robust to different specifications are often preferred. In all the estimations, I *cluster* the data by country.

Furthermore, I assume not only a contemporaneous relationship between the dependent and independent variables, but I also recognize that economic and political factors in a given year (as represented by the independent variables) may not effectively transmit to policy changes in the same year. Therefore, I introduce different lag structures in the independent variables so as to capture the impact of other possible forms of relationships between the dependent and independent variables. Specifically, the economic crisis variables, the IMF program dummy and the proxy for policy learning are examples of variables whose effect could take time to filter through the policy process and lead to financial policy change.

Given that the dependent variable used in this study is ranked according to levels of liberalization, the ordered probit method is the principal method for the estimation of each model. However, the ordered probit method is incapable of showing whether the

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independent variables affect the likelihood of liberalization differently at different states of the financial sector. That is, one cannot tell from estimation results, whether the effects of an independent variable vary depending on how "liberalized" or how "repressed" the financial sector is at the previous period. For example, does participation in IMF program have a stronger impact on the probability of financial liberalization when a country's financial sector is fully repressed than when it is partly liberalized?

To answer this question, I construct a new dependent variable, *LIBZ*. *LIBZ* takes the value of 1 when there is liberalization (i.e., when a country moves from one level to another towards full liberalization) and 0 otherwise. I perform ordinary probit estimates on *LIBZ*, under two restrictions (a) when a country is starting from a position of full repression, and (b) when starting from partial liberalization. Results of this test are expected to show whether the initial starting point influences the impact of each or some of the independent variables. Furthermore, I conduct sensitivity tests by performing probit estimates on *LIBZ* (when a country is not fully liberalized) to ascertain if results obtained from the ordered probit estimates using *LIBRANK* as dependent variable are robust to different estimation models.

In all the estimations, I restrict the number of observations to countries that were not fully liberalized in the previous year. This restriction is necessary because a country that is fully liberalized cannot go further in the liberalization scale, thus estimating the probability of liberalization in such a country is not a useful exercise. Furthermore, using these observations would diminish the reliability of the results by weakening the statistical connection between conditions provoking liberalization and actual responses.

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I perform several robustness checks to rule out the possibility of obtaining spurious results that may arise from the endogeneity of the IMF dummy, which appear to have strong effects in almost all estimations. The IMF dummy would be endogenous if its value is determined or influenced by one or more of the other variables in the model. Specifically, it could be argued that the same factors that would lead a country to liberalize are equally the factors that could lead such country to take IMF facility. For example, falling GDP or declining foreign reserves could be an important force leading a country to take on IMF facility. Where this is true and all the factors are included as independent variables in a model, results obtained from estimating the model may be biased. In order to rule out the probability that the IMF variable affects the other variables in the model, I repeat the benchmark equation without the IMF dummy from the model. Excluding the IMF dummy was meant to show whether the presence of IMF in the model captures the impacts of all the other variables in the model. If the IMF variable biases the result of the other variables, one would expect estimation without the IMF dummy to present significantly different results.

In addition, I perform three different biprobit estimates specifying IMF, high/low GDP growth, and *HIGHSERVSECTOR* (a dummy variable indicating the size of the service sector in a country) respectively, as second dependent variables in each of the three estimates. The biprobit model is a simultaneous equation model that controls for endogeneity (Ashford and Snowden, 1970). It could be argued that countries undertake financial liberalization in order to enhance GDP growth. Also, the service sector could lobby for financial liberalization so as to increase its access to credit and enhance its growth. Therefore, in some ways, IMF, GDP growth and service sector size may be

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endogenous in the model. Results of the biprobit estimates are discussed in the section dealing with robustness.

Methodological Limitations

Despite all the procedures used in this chapter to ensure the model is well specified and to rule out all forms of bias in the result, it is necessary to mention in a study of this form, any limitations that may remotely affect conclusions drawn from the analysis.

As stated above, some of the variables used in the model may be endogenous. In which case, estimation results may be biased. One way to remove this form of bias is to use instrumental variables in place of the endogenous variable. Good instrumental variables are ones that are highly correlated with the original (endogenous) variable to be replaced, but unrelated to any other variable in the equation. In this study, it is difficult to think of instruments that would be a good proxy for variables such as the presence of IMF agreement, GDP, or the size of the service sector in a country.

This study uses a single equation model to estimate the determinants of financial liberalization. A major limitation of the single equation model is its assumption of exogeneity of the variables in the equation. Without correcting for endogeneity, single equation models are likely to produce biased results in the presence of endogenous variables. Another way to avoid this problem is to use simultaneous equations in which the endogenous variables are treated as both dependent and independent variables in two or more equations, which are estimated simultaneously. Although the main results in this chapter are based on single equation models, several procedures described above have been used to ensure that conclusions derived in this chapter are valid.

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The variables used in the estimations are chosen on the basis of theory and empirical results obtained from previous studies, a summary of which is included in the previous chapter. Table 3.1 reports the correlations among the independent variables used in the basic model.

Table 3.1 – Correlation Among the Benchmark Variables

	Polity2	Durable	Valueadd	GDPg	Tradeop	LIBOR	Llib	IMF	Reserves
Polity2	1.000								
Durable	-0.099	1.000							
Valueadd	0.229	0.084	1.000						
GDPg	0.076	-0.025	-0.085	1.000					
Tradeop	0.023	-0.0187	0.011	0.062	1.000				
LIBOR	-0.153	0.140	0.019	-0.035	-0.009	1.000			
Llib	-0.076	0.053	0.009	-0.060	0.039	0.128	1.000		
IMF	0.042	-0.075	0.035	-0.051	-0.042	0.108	0.114	1.000	
Reserves	0.371	0.185	-0.033	0.044	-0.033	-0.100	-0.047	-0.200	1.000

Valueadd = value added by the service sector as a percentage of GDP
GDPg = Annual GDP growth rate
Tradeop = Trade Openness (the sum of export and import as a percentage of GDP)
Llib = Financial liberalization status of regional leaders
Other variables are as previously defined

In general, the independent variables are not highly correlated with each other. The low level of correlation signifies a reduced risk of multicollinearity. Therefore, estimation results are likely to be valid. In Table 3.2 below presents summary statistics of the independent variables.

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Table 3.2 Summary Statistics of the Independent Variable

Variable	No. of Obs.	Mean	Std. Dev.	Minimum	Maximum
Polity2	888	-2.8063	5.834	-10	9
Durable	889	12.3082	12.8362	0	81
Valueadd	866	42.5943	10.5085	4.3004	66.3378
GDPgrowth	858	3.4173	6.5935	-24.7	71.188
Tradeopenness	800	76.4227	37.7599	10.76	228.12
LIBOR	930	2.6684	2.3646	-1.35	7.4
Llib	929	0.0463	0.2102	0	1
IMF	930	0.4871	0.5001	0	1
RESERVES	849	602m	1400m	40812	10600m

The Model:

Equation 1 specifies the basic model as follows:

$$\begin{aligned} LIBRANK = \alpha &+ \beta_1 IMF_{it} \\ &+ \beta_2 GDPGROWTH_{it} \\ &+ \beta_3 RESERVES_{it} \\ &+ \beta_4 OPENNESS_{it} \\ &+ \beta_5 SERVSECTOR_{it} \\ &+ \beta_6 POLITY2_{it} \\ &+ \beta_7 DURABLE_{it} \\ &+ \beta_8 LIBOR_{it} \\ &+ \beta_9 LEADERLIB_{it} \\ &+ \varepsilon_{it} \qquad (1) \end{aligned}$$

where; $LIBRANK_{it}$ denotes the extent to which country i liberalized its financial sector at time t. *LIBRANK* takes the value of 2 if a country ends up fully liberalized, 1 if ends up partially liberalized and 0 if there is no change in the financial structure. The independent variables are as previously defined in the sub-section, independent variables.

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3.3 Analysis of Results

In the following result, I present the ordered probit estimates for each equation. In addition, I report the marginal effects of a unit change in each regressor on the two levels of financial liberalization (partial liberalization and full liberalization). The marginal effect shows the extent to which a unit change in the regressor affects the likelihood of a given outcome. A positive coefficient estimate is interpreted as increasing the probability of achieving a given state of the dependent variable, and vice versa for a negative coefficient.

It is pertinent to note that the number of observations presented in the following tables is different from the total number of observations in the dataset. There are several reasons for these differences. First, the dataset presents actual observations at given time periods, while the number of observations in the multivariate models represent episodes of financial liberalization that correspond to the model being estimated. Second, in the models, the ordered probit estimates are restricted to the countries that can liberalize in a given year, i.e. those that have either a fully repressed or only partially liberalized system. Because the aim is to measure the probability that the average country would liberalize in a given year, observations on countries that are fully liberalized in that year are not used in the estimation. The estimation program (in STATA) is given in Appendix 2.

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Table 3.3 – Ordered Probit Estimates: Benchmark Specification (Equation 1)

Variables	Model	Marginal effects (Librank=1)	Marginal effects (Librank=2)
IMF	0.5552*** (3.42)	0.0267*** (2.97)	0.0383*** (3.48)
GDP GROWTH	-0.0218** (1.98)	-0.0011* (1.82)	-0.0015* (1.82)
RESERVES	-0.0001 (0.84)	-0.0000 (0.83)	-0.0000 (0.85)
TRADE OPENNESS	0.0003 (0.13)	0.0000 (0.13)	0.0000 (0.13)
SERVICE SECTOR	-0.0067 (0.93)	-0.0003 (0.90)	-0.0005 (0.92)
POLITY2	0.0134 (1.06)	0.0006 (1.06)	0.0009 (1.08)
DURABLE	0.0082 (1.41)	0.0004 (1.35)	0.0005 (1.35)
LIBOR	-0.0372* (1.73)	-0.0018* (1.66)	-0.0025 (1.61)
LEADER LIBERALIZED	1.292*** (3.9)	0.0844*** (4.27)	0.2266*** (2.49)
Cut1	1.5251		
Cut2	1.8378		
Pseudo R^2	0.1357		
No. of obs.	526	526	526

Note: Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance at the 5% level; and *** denotes significance at the 1% level.

Table 3.3 above presents results of the basic model (Equation 1). As shown in the table, the IMF program variable coefficient estimate is statistically significant at the 1% level. This implies that countries with an IMF facility are more likely to embark on

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financial liberalization than countries without such facilities. This result is consistent with the findings in Abiad and Mody (2005). According to Abiad and Mody, IMF program has strong positive impact on the liberalization decision of countries with highly repressed financial systems. This was the case in many SSA countries prior to the 1980s. As shown in the table, the presence of IMF program increases the likelihood of financial liberalization for the average country by 2.6% and 3.8% for partial liberalization and full liberalization respectively. The marginal effect of the IMF variable (2.6% and 3.8%) may appear small if taken on its face value. However, when seen in the context of the liberalization data, the IMF variable has a very significant effect on the likelihood of liberalization in the average country. The liberalization data shows that the probability that the average country would liberalize in a given year is 4.8%.

The positive impact of IMF facilities on the likelihood of financial liberalization is not surprising because countries taking on IMF facilities also undertake to abide by the conditionalities attached to such facilities. Developing countries with precarious external financial positions often go to the IMF for financial and policy assistance, making it more likely for such countries to follow the prescriptions of the Fund. If the impact of IMF conditionalities on domestic policy choice is directly related to the economic strength of a country and the extent to which such country relies on the Fund for financial assistance, then the results shown in Table 3.3 are not surprising given the frequent use of IMF facilities by SSA countries.

Furthermore, governments of developing countries sometimes see participation in IMF programs as one route to signal to international investors that it is pursuing investor-friendly policies. This perception has been strengthened by the attitude of lenders

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participating in the Paris Club and London Club arrangements, both of which often associate participation in IMF program with good economic policies, and therefore a mandatory component of debt rescheduling agreements.

The regional learning effect, as captured by the regional leaders' liberalization status, is positively related to the probability of liberalization in other countries in the region. This result is similar to the results in Girma and Shortland (2005) and Abiad and Mody (2005). The regional learning effect may be due to the competition for international capital, as owners of foreign capital are generally more inclined to lend to countries with liberal financial markets. It could also be the result of better information and new knowledge as a country is in a better position to assess the quality of a given policy if other countries in the region have implemented that policy.

The regional learning effect increases the likelihood of partial liberalization in the average country by 8.4% and 22.6% for partial and full liberalization respectively. This variable has the highest marginal effect among all other variables. Besides the competition for foreign capital, this result could reflect the movement of ideas across borders through the interactions of policy-makers, common educational backgrounds, and other factors that contribute to the development of epistemic communities. Because of the intensity of interactions, such communities may well develop primarily in the context of specific regions.

According to estimation results, the estimated coefficient for GDP growth is negative and significant at the 5% level. This implies that high GDP growth reduces the likelihood of financial liberalization. However, the marginal effect columns show that GDP growth has a modest effect (0.1%) on the probability of partial or full liberalization

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in the average country. During periods of good economic performance, countries are more likely to maintain the status quo instead of experimenting with new policies that may present uncertain outcomes. It is therefore likely that good economic performance reduces the probability of financial liberalization, as a country may not need to change an economic framework that is currently producing desirable results.

Results in Table 3.3 suggest that an increase in the real LIBOR decreases the probability of financial liberalization.This result is consistent with the findings in Abiad and Mody (2005), which show that an increase in world interest rates reduces the probability of financial liberalization. Countries may prefer to tighten controls during a regime of high world interest rates as a way to avoid capital flight. Given two investment opportunities yielding similar returns, investors would prefer to invest in countries with lower risks. High values for the real LIBOR may make it attractive for domestic investors to take their capital to more stable countries. Governments may react to this by restricting the movement of capital, and this policy could have an impact on the domestic banking sector as well. Similarly, a poor country may see little value in liberalizing as a means of attracting capital if it is more costly, and if they consider themselves as being in a relatively weaker position to attract scarce funds. LIBOR has modest marginal effects at 0.1% and 0.2% for partial and full liberalization respectively.

Estimated coefficients on the balance of foreign reserves and value added by the service sector are not statistically significant. This means that changes in these variables do not have a significant impact on the likelihood of financial liberalization in the average country. Similarly, *TRADEOPENNESS* does not have a statistically significant coefficient estimate. This result confirms the findings in Abiad and Mody (2005), and

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implies that the level of external trade measured by the sum of exports and imports divided by the GDP does not affect the likelihood of financial liberalization is SSA countries. There are several possible reasons for this result. First, there may be very little external trade conducted in the sample countries. Second, it could be because local importers and exporters do not have strong ties to large foreign multinationals that can influence policy decisions. Furthermore, *Polity2 and Durable* are not statistically significant in the above model. This indicates that these variables do not have significant impact on the likelihood of financial liberalization in the average country in the sample.

Further estimation of equation 1 for countries at different levels of financial liberalization shows that the IMF program dummy has a strong positive impact on countries whose financial systems are fully repressed and less significant effects in countries with partially liberalized systems. With a marginal effect of 8%, the IMF program dummy seems more influential in cases of full repression as opposed to partial repression. This result, which is consistent with the findings in Girma and Shortland (2005) and Abiad and Mody (2005), seem plausible because many SSA countries began the process of financial liberalization within the framework of the IMF Structural Adjustment Program. Similarly, the *LEADERLIB* coefficient estimate is significant at the 1% level for all regardless of their state of financial liberalization, but has a stronger marginal effect when fully repressed. These results could indicate that IMF program and policy learning were important factors that made the average country in the sample abandon the status quo (financial repression) and take the initial step towards financial liberalization.

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Alternative Specifications

I explore alternative specifications of the model by examining whether the impacts of the economic variables used in Equation 1 change as the magnitude of the variables change. To this end, I construct new variables *RECESSION*, *BOPCRISIS*, and *HINFLAT* to reflect economic shocks or crisis that may alter the status quo and necessitate policy reforms. I also construct *STABILITY*, a variable for fairly stable political regimes. I use *HIGHSERVSECTOR* to reflect the structure of the economy or the relative strength of the service sector compared to other sectors. Equation 2 is specified as follows:

$$\begin{aligned} LIBRANK = \alpha &+ \theta_1 IMF_{it} \\ &+ \theta_2 RECESSION_{it} \\ &+ \theta_3 BOPCRISIS_{it} \\ &+ \theta_4 OPENNESS_{it} \\ &+ \theta_5 HIGHSERVSECTOR_{it} \\ &+ \theta_6 POLITY2_{it} \\ &+ \theta_7 STABILITY_{it} \\ &+ \theta_8 HINFLAT_{it} \\ &+ \theta_9 LEADERLIB_{it} \\ &+ \varepsilon_{it} \end{aligned} \qquad (2)$$

The variables in Equation 2 are as previously defined.

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Table 3.4 – Ordered Probit Estimates: Alternative Specification (Equation 2)

Variables	Model	Marginal effects (Librank=1)	Marginal effects (Librank=2)
IMF	0.3831** (2.09)	0.0207** (1.99)	0.0284** (2.11)
RECESSION	0.2031 (1.18)	0.0117 (1.14)	0.0167 (1.10)
BOP CRISIS	-0.0708 (0.33)	-0.0038 (0.34)	-0.0052 (0.34)
HIGH INFLAT	0.2458 (1.00)	0.0147 (0.93)	0.0219 (0.85)
H SERVICE SECTOR	0.2625** (2.10)	0.0161** (2.07)	0.0245** (1.97)
TRADE OPENNESS	0.0004 (0.14)	0.0000 (0.14)	0.0000 (0.14)
POLITY2	0.0084 (0.70)	0.0005 (0.71)	0.0006 (0.73)
STABILITY	0.3365** (1.97)	0.0197* (1.75)	0.0288* (1.72)
LEADER LIBERALIZED	1.3447*** (3.97)	0.0920*** (4.51)	0.2566*** (2.70)
Cut1	1.9580		
Cut2	2.2877		
Pseudo R^2	0.1371		
No. of obs.	440	440	440

Note: Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance at the 5% level; and *** denotes significance at the 1% level.

Table 3.4 reports estimation results of Equation 2. As shown in the table, the coefficient estimate of each of crisis variables is not statistically significant. This result suggests that economic shocks or crisis, represented by recession, balance of payment crises and high inflation, do not affect the probability of financial liberalization in SSA

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countries. This result contrasts with the findings in Abiad and Mody (2005) where it is shown that balance of payment crises increases the likelihood of financial reforms. I explored different definitions of the variables to test the robustness of the results. For example, I altered the definition of *RECESSION* to imply a situation where GDP growth is -5% or less. However, the coefficient estimate of *RECESSION* remains statistically insignificant even with the different range of values. Similarly, I explored other ranges of values for *BOPCRISIS* (when there is at least a 20% fall in foreign reserves from one year to the next) and *HIGH INFLAT* (when inflation rate is at least 80%), and the results confirmed that crisis variables had no significant impact on the probability of financial liberalization in SSA countries.

The difference between the result of this study and the findings in Abiad and Mody (2005) may be due to differences in the characteristics of the samples used in the two studies. Negative GDP growth (recession) may not be a sufficient reason for major policy changes in a country that rarely reports significant positive GDP growth. However, in other countries, even a marginal drop in GDP may bring about a policy response that would alter the status quo. Because a number of SSA countries have been plagued by harsh economic conditions in the past decades, a year or two of negative GDP growth or episodes of high inflation or balance of payment problems may not necessarily cause enough panic to necessitate dramatic shifts in financial sector policies in these countries.

As shown in Table 3.4, the coefficient estimate for *HIGH SERVICE SECTOR* is positive and statistically significant at the 5% level. This result implies that countries with a high service sector (when the sector contributes at least 60% of the GDP) are more likely to adopt financial liberalization than countries where the service sector contributes

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less to GDP. With marginal effects at 1.6% and 2.4% for partial liberalization and full liberalization respectively, this variable has a fairly comparable effect as other statistically significant variables in the model. This result seem reasonable and in line with expectation. The service sector was not traditionally part of the priority sectors, and as such was not eligible for subsidized credit during the era of financial repression. It is therefore probable that the service sector would push for financial liberalization as a way to ensure the same market conditions apply to every sector of the economy. Large service sectors are more likely to have the capacity to exert potent pressures on the government to adopt financial liberalization than are smaller service sectors.

The *STABILITY* variable, which is a proxy for stable regimes, has a coefficient estimate that is statistically significant at the 5% level. This result implies that stable regimes are more likely to liberalize than unstable ones, which is in line with expectations because stable regimes are more likely to favour liberal economic policies than unstable ones. The reason for this expectation is that stable regimes are generally at little or no risk of losing political control due to liberal economic policies. However, under an unstable government, the executive may want to exercise complete control of the economy in order to make it difficult for the opposition to amass enough resources to bring down the government. In addition, under politically unstable conditions, a government may simply be hesitant to initiate policy changes that could trigger strong reactions from potential losers of the reform. As reported in the marginal effects columns, a unit increase in *STABILITY* increases the likelihood of partial financial liberalization by 2% and 2.9% for full liberalization.

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The estimated coefficients for the IMF program variable and the impact of financial liberalization by regional leaders remain positive and statistically significant. Interestingly, the use of indicator variables for different economic episodes diminishes the effects of the IMF variable (both marginal effect and statistical significance) suggesting that (not surprisingly) the presence of these adverse economic circumstances is at least partially correlated with the presence of IMF programs.

Interestingly, results from different states of the financial sector show that *HIGH SERVICE SECTOR* has a stronger influence when a country is starting from a position of partial liberalization than when starting from full repression, perhaps suggesting that the service sector may not have had the capacity to initiate the move towards financial liberalization. Both the IMF program dummy and the dummy for regional learning have a higher impact when a country is starting from a position of full repression. The effects of the other independent variables remain largely the same across the different starting points.

Equations 1 and 2 test for contemporaneous relationships between the dependent and independent variables by measuring the impacts of the independent variables on *LIBRANK* beginning in the same year, *t*. However, given that economic shocks may take some time to filter through the policy process in order to impact policy decisions, I introduce different lags to the crisis variables to ascertain whether it takes 1 or 2 years for economic crisis to impact financial sector policies. In the same way, implementing IMF conditionalities may not be immediate, as a country may need to repeal existing legislations in order to set up new rules. I introduce similar lags to the IMF variable to capture the time it takes for a country to implement IMF program conditionality. In

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addition, given that a country may take some time to evaluate the experience of regional leaders before adopting a similar policy, I introduce lags to the liberalization status of regional leaders (*LEADERLIB*).

Consistent with previous results, none of the crisis variables have statistically significant coefficient estimates when lagged by 1 or 2 years. This result reinforces the previous results, and shows a lack of connection between declining GDP growth, a fall in foreign reserves, or high inflation, either in the current year or previous years and the probability of financial liberalization in SSA countries. The coefficient estimate for the IMF variable and the regional leader liberalization status remain positive and statistically significant at the 1% level, and the marginal effect of the IMF variable increases from 2% to 2.5%, and from 2.8% to 3.7% for partial liberalization and full liberalization respectively. Estimation results of Equation 2 with the independent variables lagged by 1 year are presented in the Table 3.5 below.

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Table 3.5 – Ordered Probit Estimates: Alternative Specification (Lagged Crisis, IMF, and *Leaderliberal* variables)

Variables	Model	Marginal effects (Librank=1)	Marginal effects (Librank=2)
LIMF	0.4970*** (2.79)	0.0252** (2.37)	0.0371*** (3.03)
LRECESSION	-0.2027 (1.01)	-0.0098 (1.03)	-0.0137 (1.10)
LBOP CRISIS	0.1376 (0.61)	0.0072 (0.60)	0.0106 (0.59)
LHIGH INFLAT	-0.0864 (0.32)	-0.0043 (0.32)	-0.0060 (0.34)
H SERVICE SECTOR	0.2018 (1.56)	0.0114 (1.60)	0.0177 (1.46)
TRADE OPENNESS	0.0002 (0.06)	0.0000 (0.87)	0.0000 (0.05)
POLITY2	0.0118 (0.86)	0.0006 (0.87)	0.0009 (0.87)
STABILITY	0.2480 (1.53)	0.0134 (1.46)	0.0202 (1.43)
LLEADER LIBERALIZED	1.3784*** (3.94)	0.0891*** (4.47)	0.2654*** (2.51)
Cut1	1.9044		
Cut2	2.2180		
Pseudo R^2	0.1432		
No. of obs.	432	432	432

Note: Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance at the 5% level; and *** denotes significance at the 1% level.

Finally, in Equation 3, I explore different scenarios by interacting some of the independent variables with others to ascertain whether some variables have different impacts when interacted with other variables. For example, while similar economic crises

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may have the same general effects, government responses to a given crisis may differ in a democracy than in an autocracy. Similarly, the presence of IMF programs during a period of balance of payment crisis or recession may induce a different response than under a stable macroeconomic environment, or when the GDP growth rate is positive. Equation 3 explores the effect of interacting the IMF program variable with the economic crisis and political structure variables as follows:

$$
\begin{aligned}
LIBRANK = \alpha &+ \gamma_1 IMF_{it} \\
&+ \gamma_2 IMF \times RECESSION_{it} \\
&+ \gamma_3 IMF \times BOPCRISIS_{it} \\
&+ \gamma_4 OPENNESS_{it} \\
&+ \gamma_5 HIGHSERVSECTOR_{it} \\
&+ \gamma_6 IMF \times POLITY2_{it} \\
&+ \gamma_7 STABILITY_{it} \\
&+ \gamma_8 IMF \times HINFLAT_{it} \\
&+ \gamma_9 LEADERLIB_{it} \\
&+ \varepsilon_{it} \qquad (3)
\end{aligned}
$$

Results of Equation 3 are presented in Table 3.6. As shown in the table, the crisis variable coefficients are not statistically significant, confirming previous results, which show that neither balance of payment crisis nor recession affect the likelihood of financial liberalization in SSA countries.

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Table 3.6 – Ordered Probit Estimates: Alternative Specification (Equation 3)

Variables	Model	Marginal effects (Librank=1)	Marginal effects (Librank=2)
IMF	0.4292* (1.90)	0.0234* (1.76)	0.0325* (1.86)
*IMF*RECESSION*	0.1854 (0.79)	0.0110 (0.77)	0.0160 (0.70)
*IMF*BOP CRISIS*	-0.2331 (0.68)	-0.0118 (0.74)	-0.0154 (0.77)
*IMF*HIGH INFLAT*	0.5695* (1.69)	0.0390 (1.54)	0.0693 (1.18)
H SERVICE SECTOR	0.1555 (1.35)	0.0093 (1.40)	0.0135 (1.35)
*TRADE OPENNESS*BOPCRISIS*	0.0021 (0.52)	0.0001 (0.51)	0.0002 (0.52)
*IMF*POLITY2*	-0.0076 (0.62)	-0.0004 (0.61)	-0.0006 (0.62)
RLIBOR	-0.0499** (2.19)	-0.0028** (2.01)	-0.0038** (2.01)
LEADER LIBERALIZED	1.4211*** (4.29)	0.0956*** (5.11)	0.2846*** (2.94)
Cut1	1.97389		
Cut2	2.0694		
Pseudo R^2	0.1355		
No. of obs.	440	440	440

Note: Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance at the 5% level; and *** denotes significance at the 1% level.

I explored several other combinations of the variables, such as *RECESSION* and *DURABLE, BOPCRISIS* and *DURABLE,* and *LIBOR* and *TRADEOPENNESS.* The results tend to confirm that economic crises as indicated by the variables used in this study do not have a significant impact on the likelihood of financial sector liberalization

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in SSA countries. However, *IMF*HIGH INFLAT* (an interaction of IMF program and high inflation) coefficient estimate is positive and statistically significant at the 10% level. The significant, albeit weak, impact of *IMF*HIGH INFLAT* could be due to some form of relationship between high inflation and the signing of IMF agreement by member countries. In many cases, IMF programs are designed to address macroeconomic imbalances in an economy and to create a stable non-inflationary environment.

As in other estimation results, the IMF program variable, and liberalization by regional leaders remain with statistically significant coefficient estimates, indicating that these variables increase the likelihood of financial liberalization in the average country. Also, *LIBOR*'s coefficient is significant and negative at the 5% level. As explained above, increasing world interest rates may create an incentive for governments to tighten controls over the financial sector in order to ensure that domestic capital does not move to safer markets.

Sensitivity Test

The preceding section has mainly focused on analyzing the ordered probit estimates. In other to check the sensitivity of the results to alternative estimation methods, I perform probit estimates on all the equations above but replacing *LIBRANK* with *LIBZ* (a binary which takes the values of 0 and 1 for no liberalization and liberalization respectively) as the dependent variable. The table below presents the result of estimating Equation 1 (above) with *LIBZ* as dependent variable:

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Table 3.7 – Probit Estimates: Sensitivity test (Equation 1)

Variables	Coefficients
IMF	0.5562*** (3.31)
GDP GROWTH	-0.0254** (2.08)
RESERVES	0.0001 (-0.73)
TRADE OPENNESS	0.0005 (0.17)
SERVICE SECTOR	-0.0063 (0.85)
POLITY2	0.0218 (1.62)
DURABLE	0.0103* (1.72)
LIBOR	-0.0486** (2.09)
LEADER LIBERALIZED	1.2979*** (3.87)
Number of observations	526
Pseudo R^2	0.18

Note: The dependent variable is the change in financial liberalization index, LIBZ. Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance at the 5% level; and *** denotes significance at the 1% level.

As shown in the above table, the results obtained from running probit estimates are essentially the same as those obtained from the ordered probit method. Similar conclusions were derived when I perform probit on all the other equations. These tests confirm the validity of results obtained from the ordered probit models and show they are robust to other estimation techniques, and are not simply the result of how we have ranked liberalization efforts by SSA countries. The difference between the probit

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estimates and the ordered probit estimates is that the probit treats every act of liberalization in the same way. It does not take into account the level of liberalization. On the other hand, the ordered probit estimates deal with dependent variables that rank the extent of liberalization, with an end result of full liberalization being taken as indicative of more liberalization effort than is required to simply get to a state of partial liberalization.

Robustness of Results

I used different techniques to check for multicollinearity in the independent variables. As Table 3.1 shows, there is negligible correlation between the variables. I also perform ordinary least squares estimation by regressing each variable on the other to observe the size of the R^2; none of the regressions show a high R^2.

The consistent significance of the IMF program dummy and the lack of significance of the crisis variable may be because *IMF* captures the effects of all the crisis variables. To test for this potential bias, I estimate Equation 2 without the IMF program variable. Results of this estimation are presented in Table 3.7. As shown in the table below, the crisis variables remain statistically insignificant. Therefore, it is not likely that the presence of *IMF* in the equation leads to any bias, especially with respect to the crisis variables.

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Table 3.8 –Ordered Probit: Without IMF Program Variable

Variables	Model	Marginal effects (Librank=1)	Marginal effects (Librank=2)
RECESSION	0.1920 (1.10)	0.0112 (1.08)	0.0166 (1.04)
BOP CRISIS	-0.1032 (0.52)	-0.0056 (0.54)	-0.0079 (0.54)
HIGH INFLAT	0.1955 (0.81)	0.0117 (0.77)	0.0177 (0.71)
H SERVICE SECTOR	0.3190*** (2.62)	0.0202*** (2.53)	0.0328*** (2.54)
TRADE OPENNESS	-0.0004 (0.12)	-0.0000 (0.12)	-0.0000 (0.12)
POLITY2	0.0113 (0.91)	0.0006 (0.93)	0.0009 (0.94)
STABILITY	0.4039*** (2.55)	0.0242** (2.19)	0.0375** (2.19)
LEADER LIBERALIZED	1.4268*** (4.21)	0.0940*** (5.12)	0.2926*** (2.92)
Cut1	1.6617		
Cut2	1.9867		
Pseudo R^2	0.1255		
No. of obs.	440	440	440

Note: Robust z-statistics are in parentheses, adjusted for clustering by country. *denotes significance at the 10% level; ** denotes significance

In addition, I use the biprobit model to rule out the presence of endogeneity bias in the model. Specifying each of IMF, high/low GDP, and size of the service sector, as potentially endogenous, the biprobit models shows that none of these variables are strongly endogenous. In all the estimations, *rho* (a measure of the significance or endogeneity) is not statistically different from zero at the 5% confidence level. In

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addition, the use of lagged IMF programs as an alternative dependent variable, as discussed previously, also indicates that endogeneity in this case is unlikely.

Concluding Remarks

This chapter has explored factors affecting the likelihood of financial liberalization in a sample of 30 SSA countries. The empirical evidence presented in this chapter suggests that the presence of an IMF program in a country increases the likelihood of financial liberalization in that country. This result is similar to that found in Abiad and Mody (2005). This result also tends to confirm the hypothesis that financial liberalization in SSA countries typically took place within the context of IMF structural adjustment programs. It could also reinforce the view that IMF program conditionalities have become important determinants of domestic policies in SSA countries.

It is pertinent to note that nothing in this chapter suggests that the IMF forced SSA countries to liberalize against their will. It is indeed possible that senior policy makers in SSA countries believed in the alleged efficiency-enhancing properties of financial liberalization and genuinely pushed for financial liberalization in their respective countries. In that case, domestic policy makers may simply have used the IMF program to strengthen their stance on financial liberalization. This argument has been made in several case studies including those of Cho (2003), Nasution (2003) and Nidhiprabha (2003). According to these studies, senior policy makers, bankers, and other domestic actors were influential in the liberalization decision in South Korea, Indonesia and Thailand. According to Ndihiprabha, the IMF supported local advocates by providing Stand-By loans to Thailand in case of capital outflows following capital account

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liberalization. The IMF's Independent Evaluation Office (IEO) made a similar claim, noting that the Fund did not ask countries to liberalize against their will, but simply provided support. Commenting on capital account liberalization, the IEO noted as follows:

> In summary, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis, but there is no evidence that it exerted significant leverage to push countries to move faster than they were willing to go (IMF, 2005, p. 94).

However, Bangura (1994) and Mkandawire (1999) have both questioned the view that IMF merely supported senior policy makers who were interested in pushing for financial liberalization in their respective countries. According to these authors, it is unlikely that financial liberalization in African countries were the result of intellectual rebirth or ideational shift of senior policy makers in these countries. The fact that liberalization took root in almost every country in the region at about the same time shows the influence of external forces above and beyond policy makers' ideas and beliefs. Otherwise one would need to show that policy makers in all the countries were undergoing the same intellectual and ideational rebirth at about the same time.

Given that I am unable to identify a database containing the thoughts and beliefs of policy makers in SSA, I could not include this variable in the ordered probit estimates analyzed in this chapter. However, a case study on the determinants of financial liberalization in Nigeria to be explored in the next chapter will test the hypothesis that senior policy makers and other local actors pushed for financial liberalization, while the IMF merely provided support to these domestic actors.

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Another significant determinant of financial liberalization shown in this study is the liberalization status of countries with the status of regional leaders. As Abiad and Mody (2005) noted, it appears that "a country was under greater pressure to liberalize the further its state of liberalization was from the region's leader" (p. 84). This result may be due to the competition effect, where countries in the same region compete for international capital in the global market for finance. Given that countries with liberalized financial systems are usually perceived as investor-friendly, it is likely that countries wishing to attract foreign capital would be inclined to liberalize, especially when other countries in the region have already implemented financial liberalization.

There is also fairly strong evidence that stable regimes are more likely to adopt financial liberalization than unstable governments. Unstable regimes with frequent regime change are more likely to maintain both political and economic controls in order to strengthen its hold of the machinery of government. Therefore, such regimes would prefer to control the activities of banks, and directly determine who has access to funds, and under what conditions. On the other hand, stable regimes are more likely to have stable political and economic institutions. In such regimes, the incumbent executive is less likely to be afraid of losing political control due to financial liberalization. Surprisingly, there is not enough evidence to suggest that political structure (democracy or autocracy) affects the likelihood of financial liberalization.

This study also tends to support the lobbying hypothesis, which posits that domestic interests not directly benefiting from financial repression policies, though policies such as subsidized credit could exert pressures on government to adopt liberal financial sector policies. According to the results, a large service sector (one that

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contributes 60% or more to GDP) increases the likelihood of financial liberalization in the average country.

There is evidence that GDP growth reduces the likelihood of financial liberalization in SSA countries. Countries with high GDP growth are likely to maintain the status quo as against experimenting with a new policy. This result seems in line with common sense, as there may not be many reasons to alter the status quo when the economy is doing well. Consistent with the findings in Abiad and Mody (2005), world interest rates, as reflected in the London Inter-bank Offer Rate, also reduces the probability of financial liberalization in SSA.

Contrary to the results of previous studies, this study could not find evidence that economic crises affect the likelihood of financial liberalization in the sample countries. While there may be no obvious explanation for this result, it could be the result of a long period of economic difficulties in these countries. It is possible that after several years of economic crisis, many SSA countries may have developed other ways of dealing with the problems than altering financial sector policies. Similarly, neither trade openness nor political structure (democracy or autocracy) has a significant effect on the likelihood of financial liberalization in SSA.

The results presented in this chapter are generally consistent with the results of other studies exploring the determinants of banking sector liberalization in developing countries in other regions. This suggests that although SSA countries are not major players in the global financial system, they are not immune to global threats, opportunities, and trends that affect the international financial market, and which place pressure on their own domestic regulatory arrangements.

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Chapter Four

Determinants of Financial Liberalization in Nigeria

4.1 Introduction

The Nigerian banking sector was characterized by extensive government intervention prior to the commencement of financial liberalization in 1987. The major features of the banking system during the pre-liberalization era were government-controlled deposit and lending rates, credit guidelines that stipulated the proportion of a bank's asset portfolio that must be reserved for various priority sectors, government's equity participation in the banks, and a mandatory rural banking scheme. These forms of intervention were designed to give the government effective control of the economy after the end of colonialism.

Foreign banks, largely owned by Europeans, dominated the Nigerian banking sector during the colonial period and for many years after political independence. Foreign banks remained the most significant players in the Nigerian banking sector until the promulgation of the Nigerian Enterprises Promotion Decree (NEPD) of 1972. The decree, popularly known as the Indigenization Decree, was meant to facilitate the transfer of strategic sectors of the economy from foreigners to Nigerians. The desire of Nigerian nationalists to regain control of the Nigerian economy from European colonial masters is demonstrated in the following extract from a government white paper issued in 1958:

> I was frustrated because of the shoddy way and manner the Manager of the Marina Branch of the Bank of British West Africa Limited treated me with rebuff. Not only did he keep me standing in his office for some minutes, but he was curt and condescending, as if I was seeking a favour...naturally my pride was hurt and it dawned on me that the struggle for Nigerian freedom had many fronts, and that political freedom was not

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> enough; economic freedom must be won also (Dr. Nnamdi Azikiwe, first indigenous President of Nigeria; cited in Nwankwo, 1980; p. 71).

In a similar manner, the National Bank of Nigeria – an indigenous bank - issued the following advertisement in the February 1952 edition of the *Nigerian Tribune*:

> By a concerted and well planned process of discrimination, the African merchants were gradually eliminated from the position of middlemen between the big European firms and the African consumers and in their place was substituted the alien immigrants. The Africans, according to plan, became small retail traders and civil servants. This economic strangulation could not have been possible if the African had had a strong financial institution of his own. Patronise the National Bank of Nigeria and retrieve your lost birth right (cited in Nwankwo, 1980; p.71).

Nationalist sentiments led to extensive controls of the banking sector, as government saw ownership and control of banks as both a symbol of economic independence and an instrument of development policy. By the mid-1970s, the Federal Government and every state government in Nigeria had interests in one or more commercial banks. The African Continental Bank (ACB), the National Bank of Nigeria, and the Bank of the North owned by the Eastern, Western and Northern regions of Nigeria respectively, were the earliest state/regionally-owned banks. By 1980, there were 20 commercial banks in Nigeria. Out of these, the Federal Government had controlling interest in 7 banks, the state governments had controlling interests in 10 banks, and private investors controlled 3 (Brownbridge and Harvey, 1998).

The state governments set up banks in order to ensure ready access to funds for development projects, as well as to provide financial services to local businesses (Nwankwo, 1980). Banks were also instruments of direct monetary control as government directed the allocation of credit to various sectors of the economy. States and

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regional banks operated within the broad policy guidelines issued by the Federal Government. Given this form of government intervention in the banking sector, why did Nigeria choose to adopt financial liberalization when financial repression afforded the government an opportunity to direct the flow of credit to priority sectors?

In this chapter, I explore the factors that influenced Nigeria's decision to liberalize its banking sector after years of financial repression. This study follows closely on the works of Lukauskas and Minushkin (2000), Auerbach (2001), and Martinez-Diaz (2005) who have examined the timing and determinants of financial market opening in developing countries. This study is different from the others because it focuses on the experience of a Sub-Saharan African (SSA) country, while the rest are case studies of Asian, Latin American and European countries. Furthermore, unlike the other studies, this chapter focuses exclusively on determining the factors that led to liberalization of the domestic banking sector. To the best of my knowledge, no study has explicitly explored factors that led to banking sector liberalization in Nigeria.

Nigeria is chosen for the case study because of its large size and its strategic place as a regional power within the SSA region. Also, Nigeria is an interesting case because it is the only country in the region that implemented financial liberalization and other components of the IMF Structural Adjustment Program (SAP) without using the IMF's financial resources. Furthermore, Nigeria's implementation of SAP has been adjudged inconsistent with the original design of the program. The country reversed several components of the adjustment program[1] after their initial implementation (IMF, 1997; Mkandawire and Soludo, 1998; Stein, Ajakaiye and Lewis, 2002). As Yin (1989) noted, an exemplary case study is one that focuses on an unusual or a distinctive case. Nigeria

[1] I use reforms, structural adjustment and adjustment program interchangeably to refer to the SAP.

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has several distinctive characteristics making it a unique case in the SSA region. Therefore, the case study evidence brings an important perspective as it could help to highlight the extent to which the cross-country evidence confirms or contradicts Nigeria's experience. In addition to serving as a plausibility probe for the hypotheses tested in the large sample estimations, case study evidence may help to identify other important factors not reflected in the estimated model, especially those for which there are no systematically collected data. Finally, the case study helps to identify how different factors interact and illustrates more clearly aspects of causality and connection that are difficult to deal with completely in large sample procedures.

Evidence presented in this study suggests that banking sector liberalization in Nigeria is largely explained by the preferences and beliefs of senior policy makers within the Nigerian government. While the study cannot point to the exact source of the senior policy makers' beliefs and preferences, it is possible that their exposure to the IMF and the World Bank through previous employment and their educational background significantly influenced their preferences. Similar to the results of the SSA study, there is evidence that pressures from the IMF and foreign creditors were significant factors in the liberalization decision in Nigeria. However, these pressures translated into financial liberalization mainly because senior policy makers in the Babangida regime were favourably disposed to structural adjustment as contained in the IMF agreement.

Contrary to the cross-country evidence, political stability did not appear as an important determinant of banking sector liberalization in Nigeria. Furthermore, there is no evidence to suggest that banking liberalization in Nigeria was the result of changes in the relative power of different sectors of the economy. Other than the government

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economic team, there is nothing to suggest that other domestic actors influenced the financial liberalization decision in Nigeria. The rest of this chapter proceeds as follows: section 2 provides a brief review of contending views on why countries embark on financial liberalization. In section 3, I comment on the case study methodology. Research findings are presented in section 4 and concluding remarks are given in section 5.

4.2 Contending Explanations

The literature on the determinants of banking sector liberalization is very limited, mainly because most studies focus on evaluating the impacts of financial liberalization. This section complements the literature review provided in Chapter 2 by reviewing contending explanations on why countries may abandon financial repression and embark on financial liberalization. Following the framework used in Martinez-Diaz (2005), I group these contending explanations into three broad sub-headings: external pressures, internal pressures, and policy emulation, learning and ideational shifts.

External Pressures

A number of political economists argue that international financial institutions, creditor and donor nations, as well as multinational corporations are key determinants of domestic policies in developing countries. Along this line, it is alleged that external pressures were the major factors influencing the move towards financial liberalization in developing countries. For example, Helleiner (1994) attributes financial liberalization in several developing countries to foreign influence emanating from the increasing power of international capital. Helleiner comments on the loss of domestic policy autonomy in African countries, and noted that foreign intrusion in domestic policy formulation makes it difficult for African countries to develop sufficient local capacity. According to him,

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"...this degree of intrusion into domestic policy formation and the concomitant failure to develop appropriate local research and decision-making capacity is not found, and would not be tolerated, elsewhere in the developing world" (Helleiner, 1994; p. 10).

In the same vein, Sachs (1996) notes that Africa's high level of dependence on foreign donors and creditors are a major reason for the extensive influence of foreigners in Africa's domestic policies. He notes that although external bodies determine African economic policies, these bodies fail to take responsibility for the outcome of such policies. According to Sachs:

> Africa is constantly berated for its poor politics and bad economic ideas, though much of the mischief has come from outside...In the 1960s, the fad at the World Bank and among many donors was *development planning*. In the 1970s, this gave way to *basic needs*...In the 1980s, basic needs was supplanted by *structural adjustment*, which rightly focused on markets but neglected to set priorities in the reform. In the ensuing frustration, the focus in the 1990s has shifted to *good governance*: donors now berate African governments for their *lack of ownership* of reforms dictated by the IMF and World Bank (Sachs, 1996; p. 20).

Similarly, Elbadawi and Ndulu (1996) highlight Africa's vulnerability to external shocks due to the continent's heavy dependence on uncertain revenue from the export of primary commodities as well as its dependence on foreign aid and loans. With a weak economic base, uncertain revenue stream, and an escalating debt service obligation, African countries are alleged to depend on external bodies for financial assistance. These bodies in turn define Africa's economic policies.

External pressures could also flow from the political and economic might of multinational corporations. Within the context of foreign direct investment (FDI), multinational corporations and other controllers of mobile capital are important sources of external influence on domestic policies in developing countries (Andrews, 1994).

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According to this view, holders of mobile capital are indifferent with respect to investing in a given country, but prefer to invest in countries with the most liberal investment rules. The actual or threatened exit of foreign capital, or the threat not to enter at all, forces developing countries to adopt liberal financial sector policies. The other channels through which external pressures flow to developing countries are the international financial institutions, and the governments of donor and creditor nations. Through various conditionalities attached to loans, aid, and other forms of assistance, external forces have played key roles in advancing financial liberalization in developing countries (Stallings, 1995).

It is pertinent to note that despite the pressures from external forces, some developing countries retain significant influence over domestic economic policies. For example, while the unrestricted flow of capital is an attraction to foreign investors; it is not the only factor determining the location of foreign direct investment. Investors also make investment decisions on the basis of market size, political risk, quality of infrastructure and other factors not related to capital controls. For investments in commercial banking, foreign banks are more likely to focus on location-specific factors, such as the size of the market, the quality of political and economic institutions, and the level of infrastructure development in deciding where to locate. Where a host country has location-specific advantages, foreign banks may not have overwhelming influence on domestic banking policies (Matinez-Diaz, 2005). Therefore, multinational corporations and other foreign investors may not be the major factor driving financial liberalization in developing countries, especially where those countries possess location-specific advantages.

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A major critique of the externalist' perspective is its tendency to understate the power of domestic actors, including the role of government in financial sector policies. As Smith (1986) noted "...dependency theory in general substantially overestimates the power of the international system...in southern affairs today...Dependency theory has systematically underestimated the real influence of the South over its own affairs" (Quoted in Auerbach, 2001, p.12). While one would acknowledge the impacts of international pressures on domestic policies in developing countries, many of these countries retain significant influence on domestic policies.

Internal Pressures

Internal pressures emanate from different sectors or groups within the country. These pressures become manifest in the form of political struggles among different interests groups such as industry groups, students' bodies, non-Governmental Organizations, and labour unions. With respect to financial liberalization, the internal pressures argument suggests that countries embark on financial liberalization as a result of pressures from domestic interest groups. Each group's collective interest determines the group's preferences, and the capacity of each group to influence public policy is determined by the group's cohesiveness as well as its relative political and economic power within the national political economy.

There are two major strands of arguments within the internal pressures perspective. First, the state and actors within the state bureaucracy are the major determinants of financial sector policies. State-centered approaches are based on the view that state interest is not simply reducible to the goals of any single group or coalition of groups (Zysman, 1983). Both politicians and bureaucrats are assumed to have

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their views and ideas, and do not simply aggregate the views of contending interest groups within the state. However, the relative power of the state in policy decisions depends on its level of policy autonomy (Evans, 1995). State policy autonomy is measured by the degree to which the executive can formulate and implement policies independent of pressures from external forces or from other arms of government. The greater the autonomy of the executive and the more insulated it is from outside influence, the greater is its ability to influence policy decisions.

Another determinant of policy autonomy within the state is the presence, in large numbers, of a professional cadre of well-educated and well-remunerated bureaucrats who have the skills and the independence to formulate policies while remaining relatively immune from outside influence (Evans, 1995). In addition, there needs to be a coherent platform and cooperation among the senior bureaucrats in the key executive organs, such as the Central Bank, the Ministry of Finance and the Office of the Head of State.

The second source of domestic influence comes from domestic economic actors represented by various sectors of the economy. According to this view, domestic businesses and bankers who desire flexibility to pursue profit opportunities as well as independence from the monetary authorities would be at the forefront pushing for financial liberalization. Similarly, economic sectors that were not benefiting from subsidized credit during the era of financial repression could lobby for the introduction of financial liberalization so as to ensure the existence of fair competition across all sectors of the economy. It should be noted that the ability of any group to have significant influence on policy decisions depends on the group's cohesiveness and its political and economic clout. While it is difficult to measure a group's political and economic clout, it

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has been argued that the contribution of a given sector to a country's GDP is a fair representation of the strength of that sector in the economy (Girma and Shortland, 2005). Sectors that contribute a high percentage of the GDP are expected to have the ability to bring potent pressures on the government to effect policy changes. Also, in democratic regimes, the level of political contribution could also be an instrument capable of enhancing a group's access to the executive. Individuals and groups who make huge contributions to the ruling political party could have strong lobbying power. Similarly, well-organized groups such as the labour unions could influence public policy by mobilizing the citizens and influencing public opinion in favour of, or against a given policy.

In addition, domestic bankers who saw financial repression as restricting their independence could lobby for the dismantling of government controls over the banking sector. However, as Coleman (1996) noted, several factors determine the ability of bankers to exert significant influence on policy decisions. These factors include, but are not limited to, the ownership and operational structure of the banks, the client base of the major banks, the role of the state in the banking system, and the strength of the bankers' association. Where the government is a majority shareholder in the commercial banks, bank managers may not have the independence to oppose government policies with respect to banking sector policies. On the other hand, private sector banks, whose primary objective is to increase stakeholders' value, could lobby for liberalization if liberal banking policies would help them achieve the goal of value maximization. Similarly, big banks with huge client base and enormous financial resources are in a better position to

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deploy resources to lobby for policy change than are smaller banks with precarious financial positions.

A major challenge with internal explanations of financial liberalization is to analyze the interplay of powers within contending domestic interest groups and to ascertain the group that had the most political and economic clout needed to influence public policy. Haggard and Maxfield (1996) discuss the importance of economic shocks in altering the balance of power among several domestic interest groups. According to their analysis, economic shocks such as balance of payment crises may enhance the relative power of domestic actors with significant foreign affiliates. These domestic actors could use the economic strength of their foreign affiliates to influence government policy, especially when the country is in dire need of foreign capital.

Policy Emulation, Learning and Ideational Shifts

Another broad category of factors that could affect a country's decision to undertake financial liberalization is policy emulation, learning or changes in the ideas and beliefs of senior policy makers. There is policy emulation when a country adopts a given policy because that policy has been implemented successfully or has produced good outcomes in another country (Hoberg, Banting, and Simeon, 2002). If banking liberalization produced desired results in one country, other countries within the region are likely to adopt similar policy. Such policy emulation may be facilitated through the co-operation usually promoted by regional organizations such as the Economic Community of West African States (ECOWAS) or the African Union.

Policy learning could result from re-evaluating the current policy in one country on the basis of a new policy introduced in another country. If policy makers were not

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convinced of the feasibility of a new policy, their reluctance may change when a similar policy is implemented in another country within the region. Other motivations for policy learning with respect to financial liberalization may be the competition for foreign capital. Countries desirous of attracting foreign capital would want to be seen as implementing investor-friendly policies. Given similar country characteristics, owners of mobile capital may prefer to invest in countries with the most liberal financial system. Therefore, most countries would not want to be identified with restrictive policies when other countries in the region are implementing financial sector liberalization.

Recently, several studies have highlighted the importance of changes in policy makers' preferences and causal beliefs as a principal factor influencing financial liberalization decisions in developing countries (Minushkin, 2000; Cho 2003; Nasution 2003; Matinez-Diaz, 2005). Sometimes these changes in preferences and causal beliefs are linked to the influence of external factors. For example, in a study of financial liberalization in Thailand, Minushkin argues that the IMF had no direct influence in Thailand's decision to embark on financial liberalization. However, she notes that IMF officials influenced Thai bureaucrats who then pushed for financial liberalization in Thailand.

Changes in beliefs could also arise from policy makers' education and training. Several studies have made the connection between financial reforms in developing countries and the education and training of senior policy makers' in these countries. Financial reforms have been facilitated by US-educated technocrats who return to their home countries with new beliefs about the efficiency-enhancing properties of market forces and the ills of protectionism (Williamson, 1994). Along the same lines, Helleiner

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(1994) argues that the influence of the economic ideas of Friedman and Hayek helped to build a "neoliberal coalition" of multinational corporations, banks, international financial institutions, central banks and Ministries of Finance. This coalition strengthened the position of local policy makers who would push for market reforms in developing countries.

According to Martinez-Diaz (2005), the decision to adopt financial liberalization in Mexico was largely influenced by senior policy makers in the Mexican government. These policy makers believed in the efficiency-enhancing properties of financial liberalization. The policy makers were made up of a cohesive group of people, and most of them had graduate training in foreign institutions. These policy makers were able to implement their ideas with relative ease because the Mexican Executive enjoyed a good measure of policy autonomy from the legislature. A major challenge with analyzing the ideas of senior policy makers is to separate the influence of the international financial institutions from the genuine beliefs and ideas of these domestic policy makers. If the IMF simply convinced senior policy makers in developing countries to believe that financial liberalization would produce efficient outcomes, then one may need to categorize the beliefs and preferences of the policy makers as part of external pressures emanating from the IMF.

Similarly, a shift in the ideas of policy makers begs the question of how those ideas get transmitted into actual policy. Presumably the transmission occurs as a consequence of the same forces that affect how domestic interest groups affect policy. As Martinez-Diaz (2005) illustrates, the capacity of Mexican technocrats to push for financial liberalization was enhanced and operationalized by an independent and

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powerful executive. In the extreme it is possible to think of external forces influencing the ideas of technocrats (as in Thailand) who then use the internal policy-making environment and internal pressures to push for liberalization (as in Mexico). Consequently one could end up with external, internal and ideational forces acting in sequence rather than as separate or competing explanations of the liberalization process. This possibility entails that one could analyze financial liberalization as a policy resulting from the interplay of different forces at the same time. A detailed case study allows us to include this possibility in the analysis.

4.3 Methodology

This case study uses qualitative analysis to explore the factors that led to financial liberalization in Nigeria. It relies on information from policy documents obtained from the Central Bank of Nigeria (CBN) and the Federal Ministry of Finance, IMF documents, and key informant interviews. Interviews were conducted in Nigeria with officials of the CBN and those of the Federal Ministry of Finance, bankers, businesses and trade associations as well as members of a Nigerian-based NGO. Interviews were conducted in different cities in Nigeria in the fall of 2005.

Interviewees were selected on the basis of their official or business positions and their knowledge of the Nigerian banking sector. The selection of interviewees was facilitated by an extensive search of important players in the Nigerian financial sector as well as my personal knowledge of Nigeria's banking industry, having worked in two commercial banks in Nigeria. Interview questions were open-ended and interviews were framed as "guided conversations" rather than "structured queries". This process implies

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that although the interviews focused on a consistent line of enquiry, the actual stream of questions did not follow a rigid pattern (Rubin and Rubin, 2005).

Interview questions were generally framed around the theoretical and empirical explanations of the determinants of financial liberalization in developing countries – external influence, internal pressures, and policy makers' causal beliefs, as well as the interactions between these forces. This approach is in line with the recommendations in Yin (1989), who suggests that relying on the theoretical propositions that led to the enquiry is the most preferred strategy to follow in a case study. Interview questions and analysis of evidence were also designed to test rival explanations and different theoretical implications.[2]

As in most case studies, this study is limited by the degree to which its findings can be generalized to other countries. By focusing on a single country or subject matter, case studies are often considered microscopic because they lack a sufficient number of observations to make for generalization. However, as Yin (1993) argued, the relative size of a sample does not transform a multiple case into a macroscopic study that can be generalized to all cases. Every study should establish its own parameters, and replicability or applicability of results flows from the methodological qualities of the case, and the rigour with which the case is constructed (Yin, 1989). Yin further highlights important principles that enhance the quality of a case study. These principles include the use of multiple sources of evidence, and the development of a chain of evidence that establishes clear links between the research questions, data collected, and conclusions drawn. This study satisfies all of these criteria.

[2] The interview protocols, sample interview questions, and other details are presented in Appendix 3.

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In analyzing the evidence, I focus on the three strands of explanations highlighted above – direct pressures from external forces, pressures from domestic interest groups, and policy makers' ideas and causal beliefs. In addition, I look for evidence of other variables that may influence a government's decision to embark on financial liberalization. These include, but are not limited to, unusual economic or political crises that may dislodge the status quo and necessitate financial sector reforms. It is realized that the decision to liberalize the financial sector may be a consequence of different factors exerting pressures on the government at the same time. Therefore, the analysis of evidence in this chapter is presented in a way that does not rule out the possibility that two or more factors had significant impacts in the liberalization decision.

I do not intend to trace the origins of senior policy makers' ideas and beliefs in Nigeria. While the study highlights notable credentials of key senior policy makers in the Nigerian government, the primary focus of analysis is to explore the extent to which the policy makers' ideas and causal beliefs impacted Nigeria's decision to embark on financial liberalization.

5.4 Explaining Financial Liberalization in Nigeria

After many years of extensive intervention in the domestic banking sector, the Nigerian government began the process relinquishing controls over the sector in 1987. Some authors have concluded that Nigeria and many other African countries implemented financial liberalization in deference to pressures from the IMF and the World Bank (Lewis and Stein, 1997; Mkandawire; 1999). According to Mkandawire, 'in the case of African countries, the enormous and unprecedented leverage of BWIs (Bretton Woods Institutions) on national economies means that changes in financial

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policies have more to do with the hegemonic positions of these institutions in the African economy…" (p. 336). In the following sections, I explore the extent to which external, internal, and learning/ideational factors influenced Nigeria's decision to embark on financial liberalization.

External Pressures

Nigeria was under the military dictatorship of General Ibrahim Babangida when the country signed on to the Structural Adjustment Program (SAP) in 1986, and began the process of financial liberalization in 1987. Prior to 1986, the World Bank had condemned the Nigerian government's extensive involvement in the economy. In a report published in 1983, the World Bank advised the government to deregulate the country's financial sector and to subject deposit and lending rates and other financial sector variables to market forces. The Bank was particularly displeased with the government's credit allocation mechanisms, controls over interest rates, and the subsidization of some sectors (World Bank, 1983). It also noted that the number of licensed banks in Nigeria was not enough to ensure competition and efficiency in the banking sector. Consequently, the Bank advised the Nigerian government to take steps to ensure that private investors took on active roles in the financial sector. At about the same time, the IMF promoted the SAP across SSA as one way of achieving economic progress in the region. The SAP was meant to provide a framework for liberal economic policies that would lead to the elevation of market forces over government controls. The SAP included a wide range of reforms, including financial sector liberalization (Mkandawire and Soludo, 1999).

Against the background of dwindling oil revenues and attendant economic difficulties, the civilian government of Shehu Shagari (October, 1979 – December, 1983)

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began negotiations with the IMF in 1981. The negotiations were designed to produce an agreement that would, among other things, enable the Nigerian government to reschedule its debts with creditors. However, talks with the IMF were inconclusive before the government was overthrown in a military coup on December 31, 1983. The incoming military administration headed by General Muhammadu Buhari suspended further talks with the IMF. Talks between and the IMF and the Nigerian government were suspended in June 1984 and for the remainder of the Buhari administration, negotiations between the government and the IMF remained stagnant (Hear, 1985). The IMF was particularly displeased with the Buhari government's opposition to structural adjustment. According to the IMF, Nigeria needed the SAP and debt rescheduling in order to focus on development goals (IMF, 1997).

The decision of the Buhari administration to suspend negotiations with the IMF and ignore pressures from the international financial institutions (IFIs) demonstrates that international forces may exert pressures but cannot force a country to adopt financial sector policies against its will. While the Buhari government resisted pressures from the international financial institutions (IFI), other SSA countries like Ghana and The Gambia negotiated IMF agreements and adopted the SAP in 1983 and 1985 respectively (Cobina, 1999). In effect, although Nigeria faced the same external pressures faced by other SSA countries, the Nigerian government's response to the pressures was different from the responses of other countries.

Nigeria's refusal to sign a stand-by agreement[3] with the IMF and the decision of Ghana to sign the agreement early in 1983 presents important issues on the impacts of external pressures in domestic policy decisions. There is the view that countries seen as

[3] A major conditionality of the stand-by agreement was the Structural Adjustment Program.

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regional leaders by virtue of their population and economic characteristics are more likely to resist external pressures longer than smaller countries. For example, Bird and Rowlands (2002) suggest that the reluctance of Nigeria and Brazil to sign IMF stand-by agreement in the 1980s was probably because the two countries are regional powers, and as such, may have a "relatively strong feeling of national sovereignty" (p. 183).

The suggestion that Nigeria's reluctance to sign IMF agreement and accept its conditionalities were, at least partly, due to the country's position as a regional power in the West African region is plausible because Nigeria and Ghana faced similar economic problems in the 1980s. Although the Nigerian government had oil, which was a major source of revenue for the country, oil earnings declined and the economy contracted drastically due to the oil glut of the early 1980s. As in Ghana, Nigeria's external debt payment fell into arrears, and as at January 1984, Nigeria's short-term arrears were estimated at $6 billion (Hear, 1985). To compound the economic problems, Nigeria's major creditors (the Paris Club and the London Club) were not prepared to reschedule Nigeria's debt if the country refused to sign IMF agreement.

Despite its apparent economic difficulties, Nigeria did not readily yield to IMF pressures. Bird and Rowlands (2002) show that Nigeria is one of the countries expected to sign IMF agreement based on predicted probabilities, but two successive governments in Nigeria (the Shagari government – 1979 to December, 1983; and the Buhari regime – January 1984 to August 1985) refused to sign the agreement. The implication is that the real impact of external pressures on domestic policies is influenced, at least in part, by other factors.

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In 1985 the government of Buhari was overthrown in a military coup that ushered in General Ibrahim Babangida as the new military Head of State. The new Head of State promised wide-ranging reforms to the polity. The reforms included the use of many educated technocrats in the policy-making machinery of government. This approach was different from that of the Buhari administration, which fielded military personnel in most senior executive positions. Furthermore, unlike the Buhari administration, the Babangida government appeared to be more willing to seek public opinion. The government also wanted to achieve some level of credibility and enhance its acceptance by Nigerians and the international community. For example, in dealing with pressures from the IMF on whether or not to implement the SAP in Nigeria, the Babangida government organized several public debates and sought the views of Nigerians on the matter. This gesture (the public debate) was a welcome development, as previous military regimes never bothered to seek public opinion on major policies.

Nigerians overwhelmingly rejected the SAP and all its policy and program components. Indeed, Nigerians did not want the government to have further negotiations with the IMF and the World Bank. According to the IMF (1997), public opposition to the SAP was not hidden in Nigeria, but was massive and sometimes violent. Perhaps Nigerians were guided by the prescriptions of the Lagos Plan of Action, which emphasized the virtues of collective self-reliance among African countries and the need for African countries to reduce their dependence on foreign countries for financial and policy assistance.[4]

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[4] Member countries of the Organization of African Unity (now African Union) ratified The Lagos Plan of Action for the Economic Development of Africa in 1980. The Plan contained far-reaching strategies on how African countries can achieve development on their own terms without having to depend on external aid and loans. The basic framework of the document was the need for collective self-reliance among

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However, against public opinion, the Babangida government negotiated a Stand-By Agreement (SBA)[5] with the IMF in 1986 and implemented the Structural Adjustment Program, which included banking sector liberalization. In deference to the people, the government refused to accept any loans from the IMF. Commenting on Nigeria's reluctance to implement structural adjustment, the IMF notes as follows; "one of the most intriguing aspects of the country's economic policy debate has been a strong resistance to structural adjustment" (IMF, 1997; p. 1).

The IMF "supported" Nigeria's adjustment effort with three SBAs between 1986 and 1992. The IMF SBA made a total of SDR 1.4 billion available to Nigeria, but the country decided "based on the result of a national referendum, not to make purchases under the arrangements" (IMF, 1997; p. 4). The World Bank also supported the adjustment program with a $450 million trade policy and export diversification loan, which the Nigerian Government used. According to the Bank, the loan was meant to enable Nigeria efforts to reshape its economy and reduce its dependence on oil exports. The loan was intended to be a vote of confidence on Nigeria's adjustment effort and it was intended to help Nigeria speed up debt rescheduling with foreign creditors.[6] Similarly, the IMF noted that the SBA provided to the Nigerian government opened the way to debt rescheduling which would help the government to focus on the demands of the adjustment programs (IMF, 1997).

African states and the need to develop effective institutions in the continent. The Plan emphasized the role of governments in the development process and blamed African dependence on the global North for most of the economic problems of the continent (OAU, 1980). Shortly after the release of the Plan, the World Bank commissioned its own report, which simply blamed the economic conditions of the continent on official corruption and government ineptitude. The World Bank report (popularly called the Berg Report) emphasized the need for market reforms in African countries (World Bank, 1981)

[5] The SBA is designed to help countries address short-term balance-of-payments problems and is the facility that provides the greatest amount of IMF resources. The length of a SBA is typically 12–18 months, and repayment is normally expected within 2¼–4 years.

[6] See *Reuters*, December 23, 1988

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It is pertinent to note that although Nigeria did not make purchases on the IMF facility in implementing the adjustment program, implementing the SAP paved the way for Nigeria to reschedule its debts with the Paris Club in October 1986 and March 1989; and with the London Club in November 1986, August 1987, and April 1989 (IMF, 1997). The presence of an IMF agreement is in fact effectively a prerequisite for debt rescheduling, since both private creditors (London Club) and official creditors (Paris Club) require evidence of the adoption of sound economic policies, which they have effectively associated with IMF agreements. Countries signing IMF agreements are adjudged to be pursuing the "right" economic policies, and are rewarded with eligibility for debt rescheduling (Stein, 1999).

Given that Nigeria was able to reschedule its public debts with the Paris Club and the London Club after signing IMF agreement, it is possible that the need for debt rescheduling was a major factor that led Nigeria to implement the SAP and financial liberalization. For the IMF and the World Bank, co-opting the creditors would become an effective tool needed to impose financial liberalization on Nigeria. However, in order to conclude that debt rescheduling was the principal factor leading the Babangida government to implement the SAP, one would need to review the circumstances of the previous administration that rejected IMF agreement. Did the previous government have no debt obligations; or was debt rescheduling more critical for the survival of the Babangida regime than for the Buhari administration?

Similar debt obligations and IMF/World Bank pressures existed during the Buhari administration. At the beginning of the Buhari's government in January 1984, Nigeria had short-term arrears estimated at $6 billion. The Buhari government refused to accept

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an IMF agreement and therefore could neither get refinancing nor rescheduling arrangements with creditors (Hear, 1985). Nigeria's oil earnings began to decline in 1981. Oil earnings accruing to Nigeria fell from $24.6 billion in 1980 to about $11 billion in 1983, $10.1 billion in 1985 and about $8.1 billion in 1986 (Hear, 1986). Simultaneously Nigeria's debt service commitment increased from 5% of oil receipts in 1980 to 30% in 1983 (Turner, 1984). As the Buhari government could not secure debt refinancing or rescheduling with creditors, it embarked on massive austerity measures. The measures involved freezing public sector wages, reducing the number of public sector employees, removal of subsidies on several commodities and reducing government expenditures generally. Although these measures are similar to the measures contained in the SAP, the government could not secure debt rescheduling because it refused to sign an IMF agreement (Hear, 1985).

Given that oil earnings continued to decline during the first two years (1986 and 1987) of the Babangida regime, debt rescheduling probably became more critical for the economic survival of that government than it was for the Buhari administration. On that basis, one may argue that the Babangida government had little option than to accept the IMF agreement and obtain the needed reprieve from creditors. When asked why Nigeria signed the IMF agreement and implemented financial liberalization, one respondent noted as follows: "I think General Babangida and his Ministers were favourably disposed to working with the IMF, but things were really bad in the country because foreign and local creditors would not do business with us. The government needed to move on, and saying, "yes" to the IMF was probably the most plausible way forward, otherwise no

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creditor would do business with us".[7] On the other hand, most respondents thought the government could have devised other ways of dealing with the economic crisis of that time instead of accepting an agreement Nigerians did not want. According to these respondents, the need for debt rescheduling was a secondary factor because General Babangida and his Ministers believed the IMF prescription would solve Nigeria's economic problems

It is possible that debt rescheduling (not debt forgiveness) would not, on its own, drive a resource-rich country like Nigeria into adopting far-reaching reforms that could have enormous political and economic implications. However, subsequent actions of the government in abandoning aspects of the SAP tend to strengthen the argument that the government merely signed the agreement in order to be able to reschedule its debts. On the suggestion that debt rescheduling was the major reason leading the government to sign IMF agreement, a respondent queried, "why did Buhari not sign on to SAP? Buhari could not get rescheduling; remember? Buhari and his advisers knew what they were doing; they wanted to find a better way to deal with the economic crisis of that time instead of running back and forth to foreign creditors. To me, it is those people – the Babangida Ministers from all those big universities who messed up Nigeria in the name of IMF program".

Nigeria's implementation of financial liberalization was as peculiar as the circumstances under which it signed on to the SAP. A few years into the reform, Nigeria suspended several aspects of the package and reversed earlier reforms. The fact that Nigeria abandoned many aspects of the program tend to strengthen the argument that the country signed the agreement simply to enable it get debt rescheduling. For example,

[7] Result of interviews held in Abuja, Nigeria in October 2005.

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after rescheduling its debts between October 1986 and April 1989, Nigeria abandoned several aspects of the reforms and began to focus on issues that mattered to Nigerians. Following massive public protests in 1989, the Federal Government lifted the ban on employment into the public service. This policy reversal led to an increase in the size of the bureaucracy, against the prescriptions of the adjustment program. The government also embarked on massive public spending in order to assuage the feelings of the people adversely affected by the reforms. This public spending increased fiscal deficits and created inflationary pressures in the economy. Some argue that the increase in government spending was a way to compensate the political and military constituents who were badly affected by aspects of the reforms.[8] According to the IMF, Nigeria officially abandoned structural adjustment in 1994, "when the Government announced a reversal of what it believed to be the misguided policies of deregulation and structural reform" (IMF, 1997; p. 1).

Another interesting aspect of the Nigerian experience is that the government continued with banking sector liberalization even after it abandoned other aspects of the adjustment program. As Lewis and Stein (2002) noted, at first "financial liberalization was a relatively low-key feature of SAP. It elicited slight commentary in the public debate over structural adjustment and produced little controversy among senior policy makers" (p. 23). According to Lewis and Stein, aspects of the adjustment program that were seen as major issues by Nigerians and senior policy makers included currency "devaluation, trade liberalization, public sector retrenchment and privatization, and the removal of subsidies on fuel and fertilizer" (p. 48).[9] However, a few years into the

[8] See for example, Stein, Ajakaiye, and Lewis (2002).
[9] This view was confirmed in interviews I conducted in Lagos and Abuja in October/November 2005.

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reforms, banking sector deregulation became the most important aspect of the program. Investment in financial services became so attractive that it elicited the interest of politicians, businesspeople, and senior military officers.

The continuation of banking sector liberalization after the government abandoned other aspects of the SAP could be because liberalization created avenue for selfish wealth accumulation by senior military officers and their cronies, or because it was difficult to reverse reforms in the banking sector. On the one hand, it would be difficult for bank customers if the government closed new banks or withdrew banking licenses already issued to new entrants, just as it may be cumbersome to re-nationalize already privatized banks. On the other hand, it is easier to re-introduce subsidies on fertilizers, increase public sector employment, or expand public spending generally. Therefore, it is plausible to argue that the nature of banking sector liberalization makes it more difficult to reverse policies already implemented towards liberalization than to reverse initiatives on the other aspects of the adjustment program. However, whether government officials chose to continue with banking sector deregulation for selfish reasons or whether the government continued with deregulation because policies could not be easily reversed , does not materially change the fact that the implementation of financial liberalization in Nigeria commenced within the framework of the structural adjustment program recommended by the IMF.

As the ongoing analysis suggests, the combination of pressures from the IMF, the World Bank, and foreign creditors was a significant force leading to the liberalization decision in Nigeria. However, the circumstances leading to the adoption of financial liberalization in Nigeria and subsequent actions of the government (such as refusing to

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make purchases under the stand-by agreement and abandoning the program half-way) show that the Government was not completely helpless with respect to the liberalization decision. While it is true that financial liberalization was initiated in Nigeria within the context of the SAP, the Babangida regime played a major role in determining when and how to implement the policy. The Nigerian experience tend to confirm the findings in Cho (2003), which states that although the IMF recommended financial liberalization to developing countries, it did not force these countries to undertake liberalization against their will. The initial rejection of the package by the Buhari administration, the rejection of IMF facility when structural adjustment was eventually implemented, and Nigeria's unique implementation of the package (intermittent suspension of the program and the reversal of earlier reforms) suggest the presence of other significant factors in the liberalization decision than simply IMF/World Bank pressures.

Like many countries in Sub-Saharan Africa, Nigeria is not a significant recipient of foreign direct investment. From the 1970s to the late 1990s, foreign direct investment in Nigeria went primarily to the oil sector.[10] Foreign corporations in the oil and gas sector such as the Royal Dutch Shell, Exxon Mobil, Texaco, Total and others have always enjoyed unrestricted inflow and outflow of funds to and from Nigeria.[11] In addition, the Nigerian domestic financial market was not developed enough to satisfy the financing needs of these corporations. Consequently, foreign corporations in Nigeria were less affected by the structure of the domestic banking sector in the pre-liberalization era, so it was not in their self-interest to invest in lobbying for financial liberalization in Nigeria. Interview respondents were unanimous in stating that there were no real pressures from

[10] See, Economist Intelligence Unit, 2005, http://www.eiu.com, Country Profile: NG (last accessed on February 5, 2007)
[11] This was confirmed in interviews with bankers in Nigeria.

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leading multinational corporations with respect to financial liberalization. In general, besides the pressures transmitted through the IMF, World Bank, and foreign creditors (most notably, the Paris Club and London Club of creditors), this study could not find other significant external pressures in favour of financial liberalization in Nigeria.

Internal Pressures

Methodologically, it is difficult to assess the level and direction of domestic pressures in a country where political and economic powers reside with the same group of people, and where there is no representative democracy that could facilitate the lobbying process. It is equally challenging to separate private sector influence from those of the government in a state where private capital and political power reside in the same group. Due to a high level of corruption in government, political officeholders and senior bureaucrats also double as major holders of private capital in Nigeria. The concentration of political power and private capital among the same group of people significantly reduces the potential for conflict between the state and capital owners. Therefore, if it is in the self-interest of government to maintain controls over the banking sector, there would likely be little overt pressures from private capital to do otherwise. In a way, the concentration of political power and private capital in the same hands can only lead to a uniform pattern of pressures from both the state and private capital.

In this section, I discuss the role of bankers and the business community in the financial liberalization decision in Nigeria.[12] Under the internal explanation for financial liberalization, there is the view that domestic bankers, who require more flexibility to pursue the goal of profit maximization, would lobby the government to adopt financial

[12] I discuss the role of the state under the next sub-section because in discussing the state I focus on the policy-making bureaucracy within government.

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liberalization. This argument reflects the case of Mexico where, as Auerbarch (2001) and Martinez-Diaz (2005) show, bankers were an important force in banking sector policies because private investors owned a significant number of Mexican banks. The pursuit of profit and the desire to compete in the global marketplace made the privately owned banks in Mexico keen on pushing for liberal banking policies. On the other hand, the government banks in Nigeria were mere instruments of domestic monetary policy, and Nigerian banks were neither committed to increasing profitability nor eager to compete in the global financial market.

There are several factors that determine the ability of bankers to influence public policy. First, the banks should be relatively strong and have enormous financial muscle. Second, most banks should be owned by private investors, and management should have a reasonable level of independence and not be under the direct influence of government. Third, bank management should have a cohesive organization, such as the Bankers' Committee in some countries. Such an organization would enable the bankers to speak with one voice on issues that affect their interests. Assessing the Nigerian banking sector in the pre-liberalization era against these measures reveal that Nigerian banks would not have had much influence on policy decisions. Banking was at an early stage of development in Nigeria in the 1980s. The banking system lacked sufficient depth to be a significant actor in the country's political economy. Unlike in Mexico, the government owned almost all the major banks in Nigeria, and government made all major decisions, including hiring and firing of senior executives. Government ownership of banks makes it less likely for bank management or the bankers' association to openly express opinions that contradict government policy.

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When asked about the role of Nigerian banks in the liberalization decision, all respondents noted that Nigerian banks had no significant influence on that decision. One respondent noted as follows: "opening up the banking sector was not a stand-alone policy consciously negotiated by all relevant stakeholders. It was all part of the adjustment program of that time. Of course, we all know that banks were not part of the decision-making machinery. The Government decided to "adjust" and that adjustment included liberalizing the banking sector..." Another respondent noted as follows: "Nigerian bankers were not powerful enough to challenge the government on banking policies; they were not cohesive enough to present a common message to the government; and most bankers did not know what financial liberalization was all about".

As a consequence of government ownership of banks, senior executive officers of banks were appointed by the government of the day. This was the case in both state-owned banks and in banks in which the Federal Government had controlling interests. Interview respondents observed that some bankers were not satisfied with what they saw as government interference with the day-to-day management of the banks during the pre-liberalization days. However, the bankers who were not satisfied with government controls could not openly express their displeasure with the system; such show of dissatisfaction could cost them their jobs. It is possible that bankers who were dissatisfied with financial repression could secretly lobby government ministers and other senior policy makers to implement liberal banking policies. Interviews with central bank officials and staff of the Ministry of Finance did not reveal this form of lobbyin from bankers.

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The view that Nigerian banks had little or no influence over banking sector polices corroborates the findings in Mkandawire (1999). On the basis of interviews and analysis of banking sector policies in Africa, Mkandawire concludes that government ownership of banks in Africa and the small size and depth of the sector reduced the sector's capacity to put pressure on government for financial sector reforms. Stasavage (1997) also confirms this view in the sub-regional context, noting that no private bank in the French West African states exhibited interest in pushing for financial liberalization. This situation is likely because with government ownership and controls of banks, bankers are likely to follow the scripts prepared by the government so as not to incur the wrath of their employer. If a senior officer of a bank wanted the government to relinquish controls over the banks, such an officer would need to resign his appointment and then seek a new platform on which he or she would challenge the status quo.

Another factor within the internal pressures explanation is the role of private businesses. According to this view, private businesses that were not benefiting from subsidized credit lobbied for the removal of subsidies and the liberalization of the banking sector. To assess the influence of the non-bank private sector in Nigeria's financial liberalization decision, I review the structure of the economy and highlight salient features of the most important sectors of the country's economy. The petroleum sector, which is controlled by the government, was and remains the most significant contributor to Nigeria's national income. The sector accounted for 87% of export receipts and 77% of Government revenue in 1988.[13] Principal actors in the petroleum sector are the large foreign multinationals such as the Royal Dutch Shell, Exxon Mobil,

[13] See Country Studies: *Nigeria – The Economy*, U.S. Library of Congress. Available at http://countrystudies.us/nigeria/52.htm (Last accessed on January 29, 2007)

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Halliburton, and Texaco. These corporations work in joint venture arrangements with the Nigerian Government to explore and market Nigeria's petroleum products. With head offices in their respective home countries, these oil companies satisfy their major financing needs through their head office. Given this structure, the oil companies had little dealings with Nigerian banks, and as such, were not important factors in setting banking sector policies.

In order of economic importance to the Nigerian Government, agriculture was next to the petroleum sector. Shortly after political independence in Nigeria, agriculture was the major source of revenue for the Government of Nigeria and the largest contributor to the country's GDP. However, the relative size of the agricultural sector began to decline when oil was discovered in commercial quantities in Nigeria. Agriculture's contribution to Nigeria's GDP shrank from 65.7% in 1959 to 30.9% in 1976, and later increased to 39.1% in 1988 (this apparent increase in agricultural sector's contribution to GDP resulted from the fall in oil export receipts during the 1980s).[14]

The agricultural sector was made up of several fringe players scattered across the country. With no efficient communication system to connect all the farmers in every village around the country, it was difficult for the agricultural sector to have a strong organization. Besides its lack of cohesiveness, the agricultural sector is probably the least likely to lobby for banking sector liberalization because it received preferential treatment and benefited from subsidized credit under financial repression. Banks were directed to devote a specified percentage of their loan portfolio for lending to the agricultural sector. The Government also established a specialized bank, the Nigerian Agricultural and Co-

[14] See Country Studies – Nigeria's Agriculture; U.S. Library of Congress. Available on: http://www.country-studies.com/nigeria/agriculture.html (last accessed January 29, 2007)

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operative Bank (NACB) to provide subsidized credit to farmers. These were in addition to other forms of subsidies given to farmers. Indeed, financial liberalization was a policy designed, among other things, to eliminate these forms of subsidies to any sector of the economy. Given that agriculture was the most favoured sector in terms of preferential credit, the sector preferred continuation of credit controls to financial liberalization.[15] On the role played by the agricultural sector in the financial liberalization decision, a respondent noted as follows: "farmers did not hide their resentment to SAP and its conditionalities. We are still complaining till this day. They killed the Nigerian Agricultural and Co-operative Bank; they let the commercial banks discriminate against farmers in lending decisions; and they stopped crop assistance. Agriculture is still suffering the pains of SAP and liberalization."

Similar to the results documented in IMF (1997) and Lewis and Stein (2002), this study found strong opposition to the SAP and financial liberalization amongst Nigerians. The Nigerian Labour Congress and the National Association of Nigerian Students were two of the most active groups that expressly opposed the introduction of the SAP. However, this opposition did not deter the government from adopting that policy. There are several factors that could explain the government's disregard for the wishes of the general public. It could be that the Babangida regime simply used the public opinion poll as a means of scoring cheap political points, when in fact that government cared little about public opinion. Alternatively, it could be that the opposition was too weak and unorganized to effectively challenge government decisions. Any one or combination of these factors could weaken the potency of pressures from the opposition.

[15] This was confirmed in interviews with members of the Chamber of Commerce in Nigeria.

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Generally, the extent to which interest groups can influence government policy is determined, at least in part, by the system of government and the responsiveness of that government to public opinion. In a representative democracy where the three arms of government exist and function independent of each other, interest groups could make their positions known through lobbying. Under the Nigerian military regime, both executive and legislative powers rested with the Head of State. Since military administrations generally do not have to operate within the constitution, and given that the head of a military government is not necessarily answerable to any other organ of government, it is not unusual for military governments to take major policy decisions such as financial liberalization solely on the basis of the preferences of the Head of State and his advisers. However, it is also true that dictatorial regimes may sometimes follow the wishes of the public in policy decisions, so as to keep constituents happy. This was not the case with respect to financial liberalization in Nigeria. The public opinion poll on whether or not Nigeria should sign the IMF agreement and implement the SAP returned overwhelming opposition to the program, yet the Government went ahead with the SAP. As opposition groups have few channels to make their views known in a military dictatorship, there were massive protests against the SAP in all major cities in Nigeria.

Based on the evidence presented thus far, this study could not identify any significant pressure originating from the banking sector or from private businesses, in support of financial liberalization in Nigeria. Besides the opposition from the Nigerian Labour Congress and the student union, expressed in anti-SAP protests, I am unable to identify any cohesive pressure from the political class either in favour of, or against financial liberalization. However, this lack of visible political activity is usually expected

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in a military dictatorship. Analysis of why the opposition from labour and student unions did not change the stance of the Babangida regime with respect to financial liberalization is outside the scope of this study.

Policy Emulation, Learning and Ideational Shifts

Senior policy makers in the Babangida administration had a significant influence on the government's decision to adopt financial liberalization in Nigeria. On ascending to power, General Babangida brought in an economic team that was made up of three Nigerian economists trained in American universities: Dr. Kalu Idika Kalu, Dr. Chu S. P. Okongwu, and Olu Falae. Dr. Kalu holds a PhD in Economics and was appointed Nigeria's Minister of Finance in 1985. Prior to that appointment, he held several top positions in economics and finance, and was Country Economist in the East Asia and Pacific Program Department of the World Bank. In 1986, Dr. Kalu was transferred from the Ministry of Finance and appointed the Minister of National Planning, while Dr. Chu Okongwu became the Minister of Finance. Like his predecessor, Dr. Okongwu holds a PhD in Economics and had worked with the World Bank before his appointment by the Babangida regime. Chief Olu Falae, an economist trained at Yale University, was the Secretary to the Federal Government. These three personalities were key members of the Babangida regime and they were directly responsible for economic policy formulation.

The government economic team was comprised of a group of economists whose actions and public utterances demonstrated a belief in the growth-enhancing properties of a liberal financial market. When asked to comment on SAP and IMF/World Bank policies in Nigeria, Dr. Kalu I. Kalu noted as follows: "There is absolutely nothing inherently evil in World Bank/IMF policies… Let me just put it very simply after all

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these years one has talked and written about this. We astounded even ourselves by the way we chose to adjust our rate of exchange... We further constrained our ability to correct the first mistake by expressly refusing the funds we needed for the system."[16] This response tends to suggest that the former Minister believed that liberalization and the SAP would have produced desired results if not for Nigeria's "wrong" implementation of the program.

Like the former Minister of Finance, other members of the economic team seem to believe that liberalization was a good policy to free the banking sector from inefficiency and allow market forces to propel the economy to its optimum growth level. For example, due to the roles played by Olu Falae in advocating for the introduction of SAP in Nigeria, Nigerians regarded him as a "fellow" of the IMF, and he was until recently referred to as "Mr. SAP".[17] Did members of the economic team genuinely hold those beliefs or was the team a mere proxy for the IMF and other external interests? There is no easy way to ascertain the source of the economic team's beliefs. However, confidential interviews with some officers who worked directly with the economic team tend to suggest that members of the team genuinely believed that financial liberalization and the other components of SAP would help turn the Nigerian economy around for good. When asked whether the Minister of Finance was simply taking directions from the IMF without believing in the efficacy of the policies, one interview respondent noted as follows: "It is not possible that the Minister of Finance did not believe in the program.

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[16] Interview granted by Dr. Kalu I. Kalu, former Minister of Finance, and National Planning. Interview was granted to the Chinua Achebe Foundation, September 28, 2005. Available at http://www.kwenu.com/achebe/2005/13kaluikalu.htm (last accessed, January 28, 2007)
[17] http://news.bbc.co.uk/1/hi/world/africa/284340.htm (last assessed on August 11, 2006)

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The man has credibility…he was a senior officer at the World Bank. In several ways, he showed he was passionately committed to the program."

Furthermore, the activities of other members of the economic team, including their public commentaries many years after the end of their service, tend to suggest that these senior policy makers actually believed that structural adjustment was an effective program to achieve economic advancement for the country. For example, in 1999 Chief Olu Falae maintained that structural adjustment was a feasible blueprint for development, but failed in Nigeria because Nigerians lacked the willpower to implement the reforms as designed. According to him, economic liberalization was an attempt to revive the nation's economy and free Nigerian farmers and businessmen from the tyranny and oppression of both the marketing board and bureaucrats who extracted rents from Nigerians through excessive controls. [18]

As noted above, the Buhari regime faced similar social and economic pressures, as did the Babangida government. In addition, both governments had similar structures and constraints: they were both military dictatorships and were not answerable to any other arm of government. However, a major difference between the two regimes is the composition of their respective Cabinet and senior policy makers. While the Babangida government had a team of economists running the economic affairs of the government, the Buhari government had no such team. The Finance Minister and head of the economic policy machinery under General Buhari was not an economist, but a sociologist and university professor. Dr. Onaolapo Soleye, the Minister of Finance during the government of General Buhari, holds a PhD in Industrial Psychology from the University of Manchester. He publicly rejected IMF prescriptions and maintained that Nigeria

[18] Olu Falae: "Why SAP Failed." *The Guardian*, Monday, February 1, 1999

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should follow a Nigerian-designed path to economic recovery bearing in mind the country's institutional peculiarities.

Other cabinet ministers in the Buhari regime also opposed structural adjustment and believed that Nigeria needed to proceed with its own policies of austerity measures in order to turn the economy around for good. For example, the former Minister of Petroleum and Energy under the Buhari government, Professor Tam David-West noted that Nigeria was in the process of turning its economy around (before the Buhari Government was overthrown in a military coup) despite its refusal to sign the IMF agreement. Commenting on the IMF agreement and the Buhari government's progress towards a self-devised economic revival, Professor David-West noted as follows:

> We would have been able to make the IMF irrelevant...and I can tell you that we were in the process of doing so. We had already received N2 billion through what I called our *repayment strategy*. London *Financial Times* of May 1984 said it was an extraordinary strategy. If Babangida had not overthrown Buhari, Nigeria should have seen the light...there was no money...but we shocked the world with good leadership and good program.[19]

This comment reaffirms the point that the Buhari government consciously refused the IMF agreement despite the harsh economic climate of that time and despite its inability to secure debt rescheduling from the Paris Club and the London Club of creditors.

In addition to the policy makers' preferences, there is the probability that policy emulation may have played an important role in Nigeria's liberalization decision. Despite Nigeria's initial resistance to structural adjustment, Ghana accepted the IMF package and

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[19] Interview with Prof. Tam David-West (Minister of Petroleum and Energy in General Buhari's regime). Interview was conducted by the Chinua Achebe Foundation on Monday, June 13, 2005. Available at http://www.kwenu.com/achebe/2005/7david_west.htm (last accessed on February 2, 2007)

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began the adjustment process in 1983. Perhaps the implementation of SAP in Ghana helped to convince the Babangida government that the adjustment program was indeed a feasible program. However, it is not likely that this factor was close in significance to the preferences of senior policy makers within the Nigerian government.[20] Being a relatively large country in SSA, Nigeria likes to provide leadership to other countries in the region. Nigeria's leadership roles in the regional organizations such as the African Union and the Economic Community of West African States (ECOWAS), and its position as a major force in peacekeeping initiatives within the region, give Nigeria the status of a regional power. While this status does not rule out the probability that Nigeria could emulate Ghana and sign an IMF agreement, it does make such an act of emulation less likely. Furthermore, if policy emulation were such an important factor in policy decisions in Nigeria, one would have expected the Buhari administration to implement financial liberalization since other countries in the region had began implementing the SAP when the government of Buhari was in power.

As the on-going analysis suggests, the trio of Dr. Kalu I. Kalu, Dr. Chu Okongwu and Olu Falae, who promoted financial liberalization and the other components of the SAP, share several features in common. All of them are economists who received graduate degrees in economics from American universities. Dr. Kalu and Dr. Okongwu also worked with the World Bank prior to their appointments as Ministers in the Babangida government. Externalists would argue that these men were effectively working for the IMF while pretending to be employees of the Federal Government of Nigeria. On that basis, financial liberalization would be seen as an imposition from the IMF. While this view may not be dismissed with a wave of the hand, one should note that

[20] This view was confirmed in key informant interviews held in Lagos and Abuja.

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the educational and employment experience of these men make them prime candidates for neo-liberal beliefs. In a sense, given the nature of their education and work history, members of the economic team do not need the IMF to convince them that markets produce more efficient outcomes than government controls.[21]

4.5 Conclusion

This chapter has demonstrated that senior policy makers within the Nigerian government (under General Ibrahim Babangida) had a significant influence on Nigeria's decisions to implement financial liberalization.[22] Although this study cannot confirm the exact source of the senior policy makers' beliefs and preferences, available evidence suggests that members of the government economic team believed that financial liberalization would enhance efficiency in the financial market and lead to economic growth. These beliefs may have been a result of team members' training in economics at American universities and/or their previous employment experience with international financial institutions. Irrespective of the source of the policy makers' ideas and beliefs, these ideas and beliefs significantly influenced government policy on financial sector reforms in Nigeria.

Furthermore, this study corroborates the findings in Lewis and Stein (1997) and Mkandawire (1999) to the effect that Nigeria implemented financial liberalization within the context of the SAP – a program that was actively promoted by the IMF. Other events such as the refusal of creditors to reschedule Nigeria's debt in the absence of IMF

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[21] It is not the intention of this study to endorse or condemn this view.

[22] It is important to note that the people who advocated for the implementation of the SAP (the economists and Federal Ministers) at the ideological level are different from the senior military officers who held political power. Consequently it would be inaccurate to suggest that the senior policy makers arguing for adjustment were themselves gaining disproportionately as individuals as a result of those policies.

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agreement tend to have enhanced the effect of pressures emanating from the IMF. Although the IMF is a significant variable in the liberalization decision in Nigeria, there is nothing in this study to suggest that the IMF imposed financial liberalization on the Nigerian government.

This study could not establish any evidence that domestic bankers and other local businesses influenced government's decision on financial liberalization. Similarly, there is no evidence to suggest that financial liberalization is more likely to occur under a stable regime than an unstable one. Furthermore, the Nigerian experience tends to suggest that political structure (democracy or autocracy) could have a significant impact on the likelihood of financial liberalization. The military regime of General Babangida ignored the views of Nigerians with respect to signing the IMF agreement and implementing structural adjustment. The government could do so because it was not afraid of being voted out of office by the people, neither was it concerned about possible legislative scrutiny. Granted that democratic governments could also disregard majority views in policy decisions, government insensitivity to public opinion is more likely to occur in autocratic regimes than in democratic governments.

Results of this study tend to question the usual practice of explaining domestic policy choice along the lines of either external "or" internal influence. While the study suggests the presence of significant external pressures in favour of financial liberalization in Nigeria, it also shows that any external pressures would have had insignificant impact on policy decisions without the buy-in of senior policy makers within the Nigerian Government. The profile of members of the economic team put in place by the Babangida regime makes it more likely that the government will be favourably disposed

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to external influence via the International Financial Institutions. Therefore, this study concludes that financial liberalization in Nigeria should be explained as a emanating from the interplay of external and internal forces. The external pressures were transmitted through the IMF and the foreign creditors, and these pressures were transformed into public policies through the buy-in of senior Ministers in the Babangida regime.

There are two major areas of similarities between the case study evidence and the large sample results presented in the previous chapter. First, both studies confirm that the presence of an IMF program significantly increases the likelihood of financial liberalization. Nigeria had an IMF program at the time it adopted financial liberalization. Although the government refused to use IMF resources, the availability of that facility made it possible for Nigeria to reschedule its debts with the London and the Paris Clubs of creditors. Irrespective of the manner or sequence in which Nigeria implemented financial liberalization and other components of the SAP, the fact remains that financial liberalization commenced in Nigeria after the Government negotiated a stand-by agreement with the IMF and began the adjustment program. Second, economic crisis did not appear to be a significant causal variable in both the large sample evidence and the Nigerian case. In contrast to the large sample evidence, there is no evidence in the Nigerian case to suggest that the domestic service sector had a significant impact on Nigeria's liberalization decision. Also, regime stability did not appear to be a significant factor in Nigeria's decision to adopt financial liberalization.

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Chapter Five

Literature Review on the Effects of Financial Liberalization on the Financial Sector

5.1 Introduction

> *The greatness of a nation and the happiness of its people do not depend so much upon the increase of its military strength as upon the spread of banks and the increase of banking facilities.*
>
> (Lord Jeffrey; cited in Wolff (1910), p. 319)

One of the many issues that appear to defy attempts to attain consensus amongst economists is the place of finance in economic growth. Over the years, several theories have explored the relationships between financial sector development and economic growth. As one would expect, many of the theories have been the guiding principles for several policies meant to bring about economic growth, especially in less-developed countries. As the search for consensus continues, it has been difficult to confirm or to dismiss Lord Jeffrey's assertion, quoted above. While some studies suggest that financial sector development leads to economic growth, others identify causality in the opposite way. A third group of studies also argue there is no causality in either direction.

Early studies on the finance-growth debate include Schumpeter (1911) who highlighted the productivity-enhancing effects of the services provided by a developed financial sector. Robinson (1952) put forward arguments suggesting that economic growth drives financial sector development as financial intermediaries innovate to meet the increasing needs of enterprises. Gerschenkron (1962), Patrick (1966) and Goldsmith (1969) all contend that financial sector development leads to economic growth and not the reverse. These authors identify the many ways through which the financial sector aids

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the flow of commerce and argue that a developed financial sector would lead to economic growth and development.

Patrick (1966) identified the financial sector in an economy as either "demand-following" or "supply-leading". In the former, economic growth creates the demand for financial services and the financial sector responds by developing financial products to satisfy the demands of industry. Under the "supply- leading" scenario, the financial sector drives economic growth through efficient financial intermediation where financial resources are mobilized from the savings-surplus units and channeled to the savings-deficit units for investment. According to Patrick, the supply-leading pattern tends to be the case during the early stages of a country's economic development and shifts to the demand-following pattern at higher levels of economic growth and development. Based on Patrick's arguments, causality could run from finance to growth or vice versa depending on a country's level of economic development. The implication is that for developing countries, causality runs from finance to growth. In more advanced economies, causality is from economic growth to financial sector development.

King and Levine (1993) and Levine (1997) use cross-country data to explore the relationship between financial development and growth. Using several measures of financial development, they conclude that financial sector development leads to economic growth and development. Other studies like Shan and Morris (2002) question King and Levine's conclusion, noting that cross-country studies cannot establish causality. Shan and Morris conduct Granger causality tests on 8 countries drawn from various regions of the world. They find "meager evidence that financial development *leads* economic growth, either directly or indirectly" (p. 153). Shan and Morris' study

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shows bi-directional causality in some countries, unidirectional causality in some, and no causality in others. According to them, differences in country characteristics influence the relationship between the financial sector and economic growth.

Despite this controversy, there appears to be a consensus that a well functioning financial sector is crucial for the smooth flow of economic activities. Against this background, financial liberalization has been implemented in many countries as a means of achieving financial sector development. Although the style and sequence of liberalization differ from one country to another, the basic principles remain the same. Financial liberalization involves a number of policy measures designed to free the financial sector from excessive government controls. It involves the deregulation of interest rates, abandonment of directed credit, privatization of the banking sector, and relaxation of entry restrictions for new banks (Reinhart and Tokatlidis, 2003). Financial liberalization may also entail capital account opening. However, the focus of this study is on the liberalization of the domestic banking sector. The rest of the chapter proceeds as follows: section 2 presents the theoretical foundations of financial liberalization, and section 3 reviews the literature on the impacts of financial liberalization on financial sector development. Concluding remarks are provided in section 4.

5.2 Financial Liberalization: The McKinnon-Shaw model

Many development economists would agree that the seminal works of McKinnon (1973) and Shaw (1973) have had the greatest influence on contemporary policy on financial sector reforms in developing countries. Ronald McKinnon and Edward Shaw argue in different ways that pervasive government controls over the financial sector

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inhibit the sector's ability to perform its roles efficiently, and retards economic growth. In different ways, McKinnon and Shaw each model a "financially repressed"[1] economy in order to demonstrate that financial liberalization is a necessary condition for financial development and economic growth.[2]

According to these authors, a high volume of savings can be generated and transformed into meaningful investment if the financial sector is allowed to operate without interference from the state. Based on the assumption that prior savings is necessary for investment, McKinnon and Shaw (MS) note that a positive real interest rate[3] will increase the volume of savings in the economy as households forgo present consumption in order to earn high rates of return. On the other hand, when there is low or negative real interest rates households have no incentive to save. Since savings is seen as a prerequisite for investment, MS suggest that positive real deposit rate would lead to higher productive investment and economic growth. Although McKinnon and Shaw arrived at the same conclusions, there are differences in their respective theoretical approaches. On the one hand, McKinnon's model is anchored on the assumption that all economic units are limited to self-finance. He makes no distinction between savers (households) and investors (firms). In his model, an investor must accumulate deposits or other financial assets in advance in order to invest in the future.

On the other hand, in Shaw's model investors are not confined to self-finance as the model permits investors to borrow to finance investment. However, in this model,

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[1] Financial repression is used to describe a financial market where there are extensive government restrictions preventing financial intermediaries from making decisions on the basis of market forces. It is usually characterized by: administratively determined deposit and lending rates, government guidelines on credit expansion and sectoral allocation, restrictive licensing of new banks, and a high level of government ownership of financial intermediaries.

[2] The McKinnon-Shaw argument is apparently anchored on the assumption that financial development leads economic growth.

[3] Real interest rate equally the nominal interest rate minus the inflation rate.

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financial intermediaries mobilize savings and deposits by raising the deposit rate beyond the inflation rate, so as to offer a positive real return to savers. By expanding the amount of savings and deposits at their disposal, financial intermediaries increase their lending capacity. Financial intermediaries also help to reduce the real costs of funds to investors through economies of scale, lower information costs to savers and investors, risk diversification, and the matching of liquidity preference among various agents.

Given that investment may be financed either internally or externally, McKinnon's self-finance approach and Shaw's debt-intermediation view do not necessarily counteract each other. Perhaps McKinnon's approach may apply more to developing economies with less developed financial systems where many economic agents may not have access to credit markets, while the debt-intermediation approach may describe what obtains in more advanced countries with developed credit market.

In summary, the MS proposition states as follow:

a) A major problem with financial sector development is government interference in the market. A government-imposed interest rate ceiling can lead to low or negative real interest rate and produces a bias in favour of current consumption. Excess consumption leads to less than optimal volume of savings in the economy.

b) A low savings volume reduces the amount of funds available for investment, making it difficult for the economy to achieve optimum growth. That is, low or negative real deposit rate result in an artificial scarcity of capital.

c) With low interest rates, borrowers are able to obtain all the funds they need at below market cost. This creates the incentive to invest in capital-intensive and low-return projects.

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A major assumption of the MS proposition is the central importance of interest rates in determining the level of savings and investment. The policy suggestion that followed from the MS analysis was the deregulation of interest rates and other financial sector variables. Until these steps are taken, MS warns that savings and investment will remain low in many countries, making it impossible to realize financial sector deepening, and economic growth and development in these countries.

A closer look at the MS proposition reveals some theoretical ambiguities. For example, the effect of a change in interest rates on consumption and savings in an intertemporal model is highly ambiguous, because its income and substitution effects tend to work in opposite directions[4]. Expected high returns on savings raises the stream of future income, and could therefore provide an incentive for households to raise current consumption. On the other hand, households may prefer to postpone current consumption because of the expectation of higher returns in the future. Given this ambiguity, MS should have focused on the nature of income and substitution effects to determine the direction of change in savings that would result from an increase in interest rates.

Subsequent studies have attempted to extend the McKinnon-Shaw framework to incorporate the effect of financial liberalization within a broader macroeconomic stabilization program. Along this line, Kapur (1976), and Mathieson (1980), have attempted to formalize the hypothesis that financial liberalization will enhance economic growth, especially in the presence of other programs designed to achieve macroeconomic stability. Kapur (1976) examines the impact of financial liberalization and stabilization policies when both policies are undertaken simultaneously.

[4] The income effect dominates when high expected future income that results from high interest rates induces households to increase present consumption and save less. The substitution effect dominates when households reduce present consumption in order to save more so as to earn the existing high returns.

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According to Kapur (1976), financial liberalization leads to an increase in the interest rate; and high interest rates enhance growth because of expected increase in the quantity of investment funds and therefore of investment. He notes that a stabilization program is likely to involve a decline in real output, because during stabilization programs, governments consciously pursue contractionary monetary policy, leading to a reduction in bank credit and by extension, a reduction in the working capital available to firms. However, with an increase in the interest rate (the likely result of liberalization) excess money supply in the system will be eliminated because households would choose to save more, or at least borrow less. Given this scenario, inflation is controlled and the increased savings level will give banks the capacity to increase the amount of credit to firms. The increase in the amount of credit available to firms would result in more investment and hence lead to economic growth.

5.3 The Impacts of Financial Liberalization on Financial Sector Development

New Bank Entry and Intermediation Efficiency

One of the major components of financial liberalization is the relaxation of entry restrictions into the banking sector and the privatization of banks previously owned by the government. The relaxation of entry restrictions into the banking sector is expected to spur the interest of domestic and foreign investors to explore opportunities in the domestic banking industry. With more local and foreign banks in the economy, there will be more competition in the market, and this should lead to enhanced availability of financial services and more efficient intermediation. Levine (2002) made the connection between the entry of foreign banks and improvements in efficiency of domestic banks.

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According to Levine, foreign banks bring with them innovations in operations and intermediation. As competition intensifies, locally owned banks would have no option but to improve on efficiency in both operations and intermediation. One of the results of such improvement would be a reduction in the cost of borrowing as the spread between lending and deposit is expected to decrease.

Weller (1999) studied financial liberalization and new bank entry in Poland and shows that liberalization brought about an increase in the number of multinational banks in Poland from 0 to 15 within a period of 6 years. Other studies such as Nissanke and Aryeetey (1998), Ajakaiye (2002) and others also confirm that financial liberalization led to increase in the number of banks in several countries in Africa. The desire to explore profit opportunities in newly liberalized financial systems is usually the force attracting local investors and multinational banks into the domestic banking sector. Contrary to expectations, Weller shows that the increase in the number of banks in Poland did not lead to significant improvement in the availability of financial services.

Similar to the results in Weller (1999), Brownbridge and Harvey (1998) show that the number of banks increased in a number of African countries after these countries implemented financial liberalization. However, there was neither significant enhancement in the quality of service in many countries nor a decline in the spread between lending and deposit rates. Furthermore, Brownbridge and Harvey note that liberalization led to the closure of rural branches and the concentration of banks in urban centers. The repeal of rural banking laws (which made it compulsory for banks to set up a specified number of branches in rural areas) and the limited viability of rural branches led banks to simply

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concentrate operations in the major centers. This further reduced the availability of banking services in the rural areas.

Interest Rates, Savings and Credit Supply

In the McKinnon (1973) and Shaw (1973) models, it is assumed that controlled interest rates lead to a low level of savings and reduces bank credit and investment. According to this view, administratively fixed interest rates are likely to result in a low or negative real interest rate. Low or negative real rates in turn would lead to an artificial scarcity of capital because households have no incentive to save under such an interest rate regime. In addition, controlled interest rates are alleged to limit appropriate risk-taking by financial institutions because such controls eliminate or reduce the scope for charging a risk premium. Therefore, in the view of McKinnon and Shaw, deregulation of interest rates would allow interest rates to increase to their natural equilibrium, and the increase in interest rates would bring about increase in savings and investment.

As highlighted in the previous section, the relationship between interest rates and the volume of savings is ambiguous given the interaction between income and substitution effects. Several empirical studies have also questioned the link between interest rates and savings. For example, Fry (1988) estimates the national savings function for 14 Asian countries for the period 1961 to 1983, and shows that savings is a function of income growth, population dependency ratio, foreign savings and the expected real rate of interest. He notes that deposit rate is not the only factor affecting savings behavior. If banks merely raised deposit rates, leaving all other factors constant, the increase in deposit rate may not lead to an increase in savings and investment.

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Similarly, Gupta (1986) uses a simultaneous equation model to examine the impact of financial liberalization in India and South Korea. According to the study, an increase in the nominal interest rate in India had a strong impact on various measures of private savings, while in Korea a decrease in inflation had a stronger impact on savings than an increase in nominal interest rate. Gupta argues that this result corroborates the argument that financial repression hinders the growth of savings and impedes financial development and economic growth. However, in a subsequent study Gupta could not confirm the results observed in India and South Korea. Using pooled time series and cross-section data from 22 Asian and Latin American countries during the period 1967 to 1976, Gupta (1987) shows that interest rate had insignificant effect on savings in the Latin American sub-sample, but had a significant effect among the Asian countries. One implication of Gupta's result is that the response of savings to a change in interest rates is not the same in every country.

Furthermore, Ogaki, Ostry, and Reinhart (1996) show that permanent income is an important factor determining household savings behavior. For households that are at, or close to the subsistence level, consumption and savings would be largely insensitive to changes in interest rates. This result implies that the response of savings to interest rates differs across households depending on household income. Similar to the impact of household income, the nature of the financial market also affect the elasticity of savings to interest rates. In an economy characterized by extensive informal financial markets, official interest rates are not likely to be a major factor in the economic decisions of agents involved in the informal market. In a way, the existence of large informal financial markets may mean that financial market policies (repression or liberalization) may not

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have many effects on the economic decisions of agents, since these agents have little to do with the official market.

Bandiera, Caprio, Honohan, and Schiantarelli (2000) analyze the effects of financial liberalization in eight developing countries, drawn from various parts of the world, for the period 1970 to 1994. The countries include Chile, Ghana, Indonesia, Korea, Malaysia, Mexico, Turkey, and Zimbabwe. Their results show no evidence of a significant positive relationship between interest rates and savings across the countries. Indeed, in some cases, most notably, Ghana and Indonesia, the relationship was a significant negative relationship. Therefore, for countries like Ghana and Indonesia, relying on increases in interest rates to generate increased savings may be misleading.

Studies exploring the elasticity of investment to interest rates have also produced mixed results. In a review of financial sector reforms in Uruguay, De Melo and Tybout (1986) show that increases in the deposit rate led to a decline in savings during the period. However, De Melo and Tybout show that aggregate private investment rose markedly during the same period. These results contradict McKinnon's premise, which suggests that savings necessarily precede investment. De Melo and Tybout note that the increase in private investment during the reform period was a result of other government policies that encouraged private investment. For example, the capital income tax was reduced during the reform period, and restrictions on the import of capital goods were also lifted during the same period.

In a study of Turkey for the period 1964 to 1986, Rittenberg (1991) show that the volume of investment is positively related to the negative real interest rate. According to the study, financial liberalization caused a downward shift in investment because of

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increased uncertainty, and because the interest rate was too high for investors to earn a positive return on investment after providing for interest expense. Rittenberg's results do not contradict those of De Melo and Tybout because the latter noted that the observed increase in investment during financial sector reforms in Uruguay did not arise from increases in interest rate, but resulted from other policies that encouraged private investment. From another perspective, it is possible to arrive at Rittenberg's conclusion if high interest rates encourage households to cut down consumption in order to increase household savings. At a given income level, an increase in the amount of savings will reduce the aggregate demand for goods and services. A fall in aggregate demand would reduce corporate revenue and necessitate a reduction in investment. However, this scenario would be different if the increase in savings came from non-traditional users of the formal financial markets. In that case, the increase in domestic savings would simply be a result of redistribution from the informal to the formal financial market.

With respect to domestic credit, financial liberalization has produced different results in different countries. Reinhart and Tokatlidis (2003) study the effects of financial liberalization in 29 Sub-Saharan African countries and conclude that financial liberalization has not enhanced the volume of credit in the average country in the sample, although the real lending rate increased in these countries. However, their results show that credit aggregates improved in a sample of other developing countries drawn from other continents. Using different indicators of financial sector development, Reinhart and Tokatlidis compare the effects of financial liberalization in low- and middle-income countries,[5] and report as follows: "the low income group differs from the middle-income

[5] The classification of countries in the sample by income level is based on the World Bank's classification for the year 2000, as contained in the *World Development Indicators*, 2000

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group in almost every respect; that is, according to almost every aggregate indicator used in this study" (p. 71).

According to Reinhart and Tokatlidis (2003), financial liberalization led to a substantial increase in the real lending rate in both the low- and the middle-income countries. However, in terms of volume of credit in the economy and other measures of financial development, the middle-income countries recorded significant improvement as against the stagnation and outright deterioration observed in the low-income countries. Such differences may be attributable to the initial starting conditions, mode of implementation of the reforms, or other institutional characteristics.

Nissanke and Aryeetey (1998) evaluate various measures of financial sector development in four African countries and observe that financial liberalization has not significantly enhanced financial development in these countries. According to them, the financial sectors in Ghana, Malawi, Nigeria and Tanzania have not fully stabilized since the beginning of the reforms. Similarly, in a review of financial market reforms in Africa, Aryeetey and Senbet (2004) conclude that financial development has remained slow in many African countries. They show that service delivery in the financial sector remains of poor quality, savings mobilization has produced inconsistent results, and banking system credit to the economy has not improved significantly. In addition to these results, bank failures and financial sector distress became endemic in many African countries following financial sector reforms. This instability further constrains the ability of banks to increase lending to the private sector.

As part of a comprehensive study of banking sector policies in Africa, Borwnbridge and Harvey (1998) conduct case studies of financial liberalization in 11

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Sub-Saharan Africa countries (Botswana, Ethiopia, Ghana, Kenya, Malawi, Nigeria, Tanzania, The Gambia, Uganda, Zambia, and Zimbabwe). They show that financial liberalization did not lead to significant improvements in several measures of financial development in many of the countries surveyed. According to the study, financial deepening improved in Gambia, Kenya, and Ethiopia where government controls were relatively mild during the era of financial repression, but declined in Nigeria, Zambia and Zimbabwe. According to Brownbridge and Harvey, financial liberalization tends to produce better outcomes in countries where the starting conditions were not one of excessive government intervention. Given that many African countries had previously pursued fairly vigorous interventionist policies, it would be difficult for financial liberalization to produce the hypothesized results. This outcome could be because the financial sectors of these countries had not developed effective structures to support liberal financial sector policies at the time of implementing financial liberalization.

The on-going review of the impacts of financial liberalization on financial sector development has shown that liberalization has produced different results in different countries. There are two important questions arising from this review: why would liberalization of interest rates lead to a reduction instead of an increase in the volume of credit? Why has financial liberalization produced different results in different countries? On the first question, adverse selection – a consequence of imperfect information could bring about a decrease in bank lending even when interest rates are up. Adverse selection in the financial market occurs where a bank selects low quality (most risky) borrowers from a pool of borrowers (Hellman, Murdock, and Stiglitz, 2000). Adverse selection occurs because banks may not have perfect information on the quality of borrowers and

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on the project for which a loan is being made. When interest rates rise, as the financial liberalization proposition suggests it should, the cost of borrowing would rise and banks may have an opportunity to earn more revenue from loans and advances. But an increase in borrowing cost also implies that net returns on business projects would fall, as businesses deduct the cost of borrowing from project cash flows. The increase in borrowing cost following a rise in interest rates may make several low-risk and low-return projects unviable, as net returns on such projects may be negative.

As Stiglitz and Weiss (1981) argue, the most risky borrowers are the ones likely to take out loans during periods of high interest rates. Good borrowers with low-risk and low-return projects are likely to stay away from the credit market because expected returns from less-risky projects may not justify borrowing at high interest rate. Given that banks do not have perfect information about borrowers and their projects, risk-averse banks may either ration their asset portfolio or stay away from the loan market. Under such a situation, the volume of credit would decrease and credit rationing may persist even under liberalization.

For the second question, institutional economists would attribute the observed differences to the institutional peculiarities of the different countries under study. For example, Acemoglu, Johnson and Robinson (2001) highlight the importance of institutions in economic growth. They demonstrate that institutional endowments explain much of the differences in economic performance across countries. Similarly, North (1990), Rodrik (1999), and others emphasize the importance of institutions in translating policies and programs to desired outcomes. On the financial sector, Gibson and Tsakalotos (1994), Stein (1994), and Arestis and Stein (2005) note that financial

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liberalization would likely produce unintended consequences if undertaken where there are inadequate institutional arrangements. As Gibson and Tsakalotos noted, financial markets do not exist in a vacuum, and it would therefore be inappropriate to simply focus on liberalizing the sector without paying attention to other structures that would make liberalization work. These structures include, but not limited to, adequate regulatory and supervisory frameworks, effective and impartial agencies to facilitate the interpretation and enforcement of contracts, and information gathering agencies, such as a credit bureau, that may help reduce the level of information asymmetry in the credit market.

By placing emphasis only on getting the price right, financial liberalization assumes all required structures are in place, such that market forces would necessarily produce efficient outcomes. However, the presence of imperfect information and other forms of market imperfections make this assumption questionable, if not untenable. Adequate institutions would help reduce the adverse effects of imperfect information by gathering information from individuals and households and making this information available in a way to assist in decision-making.[6] Similarly, adequate regulatory codes and supervisory capacity in the financial sector is needed to provide checks and balances on imprudent behavior by banks. As Gibson and Tsakalotos (1994) suggest, while competition may help to improve functional efficiency, it could also lead to financial instability, especially where there are inadequate institutional arrangements to regulate the activities of banks.

Simply removing government controls over credit allocation and interest rates, and relaxing entry restrictions into the banking sector would not lead to financial sector

[6] In the credit market, a credit bureau is one such institution

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development if not supported by well functioning institutions. Arestis and Stein (2005) disaggregate the financial system into five institutional components:

a) *Norms*, which provide behavioral guides like rules of thumb, the development of trust and professional habits that encourage probity, arise through social esteem and sanction within established patterns of banking.
b) *Incentives*, which focus on the rewards and penalties that arise from different modes of behavior within financial systems, although it may be noted that rewards are a more important dimension of this component.
c) *Regulations* that constitute the legal boundaries that help set the rules of operation and interaction of institutions in financial systems.
d) *Capacities*, which are related to the underlying capabilities of the constitutive members of organisations to operate in an effective manner to achieve the goals of a financial organisation within the confines of its norms and rules.
e) *Organisations* that are legally recognized financial structures, which combine groups of people with defined common rules and purposes. (p. 388)

According to Arestis and Stein, these components operate in an interactive manner to produce specific outcomes. Where some or all of these institutional components are missing or inadequate, financial sector liberalization may not produce desired outcomes.

Financial Liberalization and Financial Sector Instability

The effect of financial liberalization on financial sector stability has received enormous attention since many developing countries began the process of financial sector reforms. Many studies have linked the banking sector crises experienced in a number of developing countries to financial liberalization in these countries. Before reviewing some of these empirical studies, it is proper to highlight theoretically some of the factors that could make a liberalized financial sector prone to crises and instability.

In a liberalized financial system, interest rates are not subject to ceilings. This implies that banks are able to take on high-risk projects and charge a commensurate risk-

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adjusted interest rate. When banks invest in risky projects, the aggregate risk profile of the entire asset of the banking sector increases and the risk of bank failures increases as well. However, it should be noted that if banks hold well-diversified portfolios (portfolios that balance risky assets with low-risk ones), financing risky projects might not necessarily increase the risk of bank failure. But, portfolios with risky loans are generally more susceptible to problems, even when there is some level of diversification. A portfolio with high-risk assets is more difficult to manage because of the complexities of monitoring both the borrower and economy-wide changes. Effective monitoring of risky assets requires a high level of sophistication for loan officers. Such a level of sophistication may be in short supply in a country that is just emerging from an era of financial repression. To the contrary, low-risk portfolios are typically more resilient, easy to manage, and are more likely to withstand economic downturns.

Furthermore, given that financial liberalization leads to increase in the number of banks, there may be intense competition among banks to attract and retain customers. Under a high level of competition, banks are more likely to take on more risk in order to maintain market share. The appetite for more risk becomes larger due to the limited liability of bank owners as well as the presence of implicit or explicit deposit guarantees from the government. Because an increase in the number of banks may imply that a few banks no longer enjoy monopoly profits, the cost of losing a banking license when the bank becomes insolvent is reduced and so bank managers have the incentive to take on more risks (Hellman, Murdock, and Stiglitz, 1994). As Demirguc-Kunt and Detragiache (1998) note, "unless these perverse incentives are controlled through effective prudential

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regulation and supervision, increased risk taking due to moral hazard can become a powerful source of financial fragility" (p. 88).

Similarly, given that interest rates are more likely to change regularly in liberalized financial systems, banks may be more prone to crises that could arise from a mismatch between short-term deposit liabilities and long-term assets. The mismatch of assets and liabilities could arise because banks usually take on short-term deposits from several depositors and lend long-term to borrowers. Without a proper matching of assets and liabilities during a regime of volatile interest rate, banks may be unable to meet maturing obligations as at when due.

Empirically, a number of studies have explored the links between financial liberalization and financial sector crises. Radelet and Sachs (1998) show that the recent financial sector crisis in East Asia was the result of some forms of panic caused by emerging weaknesses, including policy inconsistencies. The authors argue that massive capital flows in the region - a result of financial liberalization - precipitated financial crises due to the increase in lending and borrowing in foreign currency. The East Asian countries became exposed to international currency movements when their domestic banking systems and economies were not strong enough to withstanding the volatility associated with such exposure.

Similarly, Sachs, Tornell and Velasco (1996) attribute the financial crisis in Mexico during the 1990s to a drain of foreign exchange as well as the short-term dollar debt burden that affected many sectors of the economy. The high level of foreign currency transactions and the explosion of dollar-denominated debts in Mexico were made possible by liberalization. Sachs, Tornell and Velasco argue that some form of

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restrictions on the Mexico's capital account would have made it difficult for financial speculators to engage in the level of speculative activities that led to the Mexican financial crisis.

Demirguc-Kunt and Detragiache (1998) estimate the relationship between financial liberalization and banking crises in a sample of 53 countries during the 1980-1995 periods. The sample is made up of countries from several continents, including developed and developing countries. The study uses a multivariate logit model to estimate the probability of banking crises, and tests the hypothesis that a liberalized financial system increases the probability of banking crises. In the model, a dummy variable for banking crisis, which takes the value of one if there is a crisis and zero otherwise, is the dependent variable and a measure of financial liberalization (based on observed policy changes) is an independent variable. To qualify as a banking crisis under the study, an episode of banking distress has to have at least one of the following characteristics: the ratio of non-performing assets to total assets in the banking system must be at least 10%; the cost of rescue operations for the banking sector must be at least 2% of GDP; banking sector problems result in a large-scale nationalization of banks; or extensive bank runs occurred, leading to emergency rescue measures for the banking sector.

Demirguc-Kunt and Detragiache (1998) show that financial liberalization increases the likelihood of crises, noting that banking crises are more likely to occur in liberalized financial systems than in non-liberalized systems. The authors estimate the effects of institutional quality on the relationship between financial liberalization financial sector crises. They use six measures of institutional quality, including GDP per

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capita, the extent of bureaucratic delay, the quality of contract enforcement, the quality of bureaucracy, and the degree of corruption. Their analyses show that financial liberalization is less likely to lead to a banking crisis in a country with strong institutional structures.

In another study, Weller (2001) evaluates the relationship between financial liberalization and banking crises in a sample of 26 countries spread across every region of the world. The study tests a number of hypotheses, including the hypothesis that deregulation leads to financial fragility by encouraging more speculation in the financial market. It is argued that short-term speculative capital flows may not enhance the level of real investment, but will instead contribute to financial crises as speculators move funds around at their own behest. Inflows of speculative capital could lead to short-term and unsustainable rise in asset prices; but with time, asset prices begin to move down to their real values. The result could be deterioration in the asset quality of banks as default risk rises and investors scramble to move their funds to safer markets. Weller's results confirm the hypothesis that financial fragility is more likely to occur during financial liberalization.

There are important implications in the results shown in Weller (2001) and Demirguc-Kunt and Detragiache (1998). Each of the studies focused on different countries drawn from different regions of the world. The *sequence* and *pace* of financial liberalization were not the same across the samples used in the two studies. However, despite the different sequence and pace of financial liberalization, the results of the two studies indicate that there is an increased likelihood of financial crises following liberalization. The results shown in Demirguc-Kunt and Detragiache, and Weller (2001)

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tend to challenge McKinnon's (1991) proposition that an *optimal sequence* of financial liberalization would ensure that liberalization produced the hypothesized results. If the sequence of liberalization does not significantly reduce the risk of banking crises, there is the need to search for alternative explanations, and the role of institutions in ameliorating the risk of financial sector crises may be a useful starting point.

Similar to the results in Demirguc-Kunt and Detragiache (1998), Lewis and Stein (1997) note the banking crises that occurred in Nigeria during the 1990s could be attributed to the weak institutional structures in the country both prior to and during the period of financial liberalization. Lewis and Stein note that the regulatory structures were weak and incapacitated by a lack of transparent political leadership. The weak regulatory structure made it possible for many new banks to focus mainly on "rent-seeking, and fraud, rather than conventional intermediation" (Lewis and Stein, 1997; p. 8). Given the inability of regulators to cope with the enormity of monitoring the many banks that secured licenses and began operation in Nigeria, bank failures were a natural result of the reforms.

In addition to institutional weaknesses, moral hazards arising from imperfect information could also increase the likelihood of banking crises following financial liberalization. In an environment of fierce competition, bank managers have the incentive to undertake risky projects, even if only to attract and retain clients. There is moral hazard on the part of the bank because a bank may invest in a prudent project with moderate returns or use depositors fund to invest in risky projects with a high probability of failure and a small probability of high returns. According to Hellman, et al (2000), financial liberalization leads to increased competition amongst banks. Increased

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competition erodes profit and lower profits imply lower franchise values for banks.[7] With lower franchise values, banks have less incentive to embark on a prudent strategy as such a strategy is not likely to shore up franchise values. If increased competition is more likely to force banks to embark on the gambling strategy[8] than on prudent investing, one could argue that financial liberalization is likely to exacerbate moral hazard behavior.

Although banks may elect to embark on the gambling strategy, depositors whose funds are put at risk cannot observe most of the bank's activities. If depositors could perfectly monitor the activities of banks, depositors would move their deposits away from risky banks and through that action discourage imprudent investing by banks. However, because depositors do not have enough information to penalize erring banks, a bank may opt for the gambling strategy in the face of competition because if the strategy pays off, the bank would earn high profit; otherwise, depositors may lose their deposit.[9] Smaller banks and banks with precarious financial conditions are more likely to embark on the gambling strategy, because such banks need a big push in order to strengthen their financial position, or sink otherwise. In such a situation, bank managers may see the gambling strategy as the only option available to the bank to strengthen its financial health. This has been described as a case of "gambling on resurrection" (Cole, McKenzie and White; 1995).

It is sometimes argued that high capital requirements may act as an incentive for banks to embark on prudent behavior in order to preserve owners' equity. In this way,

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[7] Franchise value is defined as the capitalized value of expected future profits.

[8] Gambling strategy is used here to refer to a strategy where banks knowingly invest in very risky projects with a small probability of very high returns and a high chance of losing the investment. If the strategy pays off, a bank would make high returns, otherwise the bank and depositors lose.

[9] In countries where there is deposit insurance, the government reimburses depositors according to the terms of the deposit insurance scheme. In Nigeria as at 2005, depositors are insured up to a maximum of N50,000 (about US$500). This level of insurance is clearly inadequate especially for depositors whose deposits run into millions.

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capital requirements may induce banks to adopt a prudent investment strategy instead of the gambling strategy. The idea is that if banks were forced to hold a huge amount of money in owners' equity, bank managers would realize that the owner's equity is also at risk if the bank fails. If bank owners have enough of their funds invested in a bank, they internalize the adverse consequences of following a gambling strategy, and the level of moral hazard may be reduced.

In order for capital requirements to help reduce moral hazard, banks must be forced to hold an inefficiently high level of capital to provide enough incentive to avoid the gambling strategy (Hellman, Murdock, and Stiglitz, 2000). On the one hand, if capital requirements are not very high, banks may still opt for the gambling strategy when it is felt that a positive result from the strategy outweighs the potential loss of equity that may arise if the gamble fails. On the other hand, where capital requirements are inefficiently high, the return on equity from prudent investment may be rather low. Hence high capital requirements may indeed encourage the gambling strategy as the only way to ensure good returns to shareholders. Hellman *et al* recommends other forms of prudential regulations as a way to discourage imprudent behavior.

5.4 Concluding Remarks

As shown in this literature review, financial liberalization has at best produced mixed results across the world. However, its effects have been largely negative in Sub-Saharan Africa. While some studies attribute the observed negative effects of liberalization to incorrect sequencing and wrong implementation, others blame the extensive controls that characterized African financial markets prior to financial

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liberalization. In the same vein, macro instability and fiscal indiscipline are sometimes blamed for the failure of financial reforms. The fact that financial liberalization sometimes produced perverse results in countries outside of Sub-Saharan Africa shows that its failure is not simply a result of regional characteristics.

It seems that much of the problems of financial liberalization could be traced to its theoretical foundations. By emphasizing interest rates as the major determinant of savings and investment, financial liberalization assumes away other factors that have a significant impact on savings behavior. In addition, by relying on the competitive equilibrium model, financial liberalization assumes that the private ownership of banks would lead to more competition in the banking sector and enhance efficiency in intermediation. However, there are fundamental differences between the competitive model and the real world of finance. In the real world, information asymmetry is endemic in financial markets. Information asymmetry leads to moral hazards and adverse selection, thereby weakening the efficient functioning of financial markets. Institutions are therefore needed to collect, process, and transmit important information to financial market participants so as to reduce these risks.

In the McKinnon-Shaw argument, markets would set equilibrium deposit and lending rates to balance the supply and demand for savings and investment. Interest rates would provide the right signals to savers and borrowers, and banks would simply intermediate between the two for a minimal spread (due to competition). In such a world, market rates would produce Pareto optimal results and there is no need for institutions. However, as demonstrated in many of the empirical studies reviewed above, interest rates do not necessarily provide the right signals. Interest rates are only one dimension of

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finance, and finance is a complex institution that operates within a broad system of other non-financial institutions. The financial crises that followed financial liberalization in many countries, and the failure of liberalization to produce desired results in many countries, underscore the need for alternative approaches to financial sector reform. It is pertinent to note that nothing in this review suggests that financial repression is a better alternative to liberalization. Perhaps reviewing the theoretical foundations of the MS framework or searching for a mid-point between repression and liberalization would produce better outcomes.

As this literature review has shown, several studies have explored the impacts of financial liberalization and financial sector development. Both case studies and cross-country evidence have been unable to provide a unanimous result with respect to the impacts of financial liberalization on financial sector development. Against this background, the next chapter seeks to contribute to the literature by providing an in-depth analysis of the effects of financial liberalization on the following financial sector variables in Nigeria: number and geographical spread of banks, trends in interest rates, volume of savings, credit supply, intermediation efficiency, and bank failures. This approach differs from previous studies because a more analytical rather than a descriptive approach is used, and because of the use of key informant interviews to supplement the analysis.

Furthermore, most of the studies reviewed above focus almost exclusively on the impacts of financial liberalization on measures of financial sector development.[10] This focus on financial variables is sufficient where the principal objective of the enquiry is to

[10] An important exception is Auerbach (2001) who made the link between liberal banking policies and the emergence of a powerful "financial elites" in Mexico. Similarly, Lewis and Stein (1997) observed that financial liberalization provided the framework for reallocating rents among Nigerian elites.

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test the McKinnon-Shaw hypothesis. The next chapter intends to contribute to the literature by exploring the effects of financial liberalization on financial sector variables, as well as its effects in the redistribution of economic and political powers in Nigeria. Specifically, the study assesses the extent to which financial liberalization facilitated the emergence of new elites outside the traditional military and political class in Nigeria.

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Chapter Six

The Effects of Financial Liberalization in Nigeria

6.1. Introduction

Nigeria began the liberalization of its financial sector with the deregulation of interest rates in 1987. Financial liberalization was a component of a broad Structural Adjustment Program (SAP) actively promoted by the World Bank and the IMF as a blueprint for economic development. The SAP was a set of policy instruments designed to bring about a transition from government-dominated economies to market-oriented ones. In the view of the Bretton Woods institutions, structural adjustment would help to move Africa's economies away from excessive government control and induce sustained economic growth and development.

Initially, financial liberalization as a component of structural adjustment did not elicit much attention and public commentary. Other components of the SAP such as the removal of subsidies on petroleum products and agricultural produce, the imposition of an embargo on new public sector employment, and a general reduction in government social spending had more immediate and observable effects on the populace. However, one year into the reforms, deregulation of the banking sector took center stage within the government and business circles and dominated all other components of the program (Lewis and Stein, 2002). When investors and politicians realized that owning a bank could provide them with enormous economic, and ultimately political, power, banking deregulation became the predominant aspect of the SAP in the minds of the rich and powerful individuals.

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Prior to financial liberalization in Nigeria, the country's financial sector was characterized by regulated interest rates, sectoral credit allocation (where the government directed banks to devote a specified percentage of their loan portfolio to identified sectors of the economy), limits on domestic credit expansion, restrictions on the use of foreign currency, stringent entry conditions into the banking sector and significant government equity participation in the sector, as well as general inefficiency and a poor customer service culture in banks. Indeed, Nigeria fit the classical definition of financial repression exceptionally well. [1] Financial liberalization was therefore an attempt to free the market from these forms of repression and to encourage financial sector development and economic growth.

The liberalization process began with the relaxation of foreign exchange controls, making it possible for the exchange rate of the Nigerian currency (Naira; N) to other currencies to fluctuate according to demand and supply. Other aspects of the reforms were liberalization of entry into the banking business, deregulation of interest rates, and relaxation of credit allocation guidelines. For example, in 1987 all controls on interest rates were lifted, and the number of priority sectors for the purpose of credit allocation were reduced from 4 to 2 (Ayogu, Emenuga and Soludo, 1998). In addition to these measures, the Nigerian Deposit Insurance Corporation was established in 1989 to complement the Central Bank of Nigeria's (CBN) supervisory and oversight responsibilities. Furthermore, the minimum capital requirement for commercial banks was successively increased from N10 million in 1985 to N50 in 1991, and the capital requirement for merchant banks was increased from N2 million to N40 million during the same period (CBN, 1993).

[1] See Chapter 5 for a brief discussion of financial repression.

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A peculiar aspect of financial liberalization in Nigeria was inconsistency in implementing all aspects of the program. Within a few years of their initiation, some aspects of the financial reforms were abandoned and some initial changes were reversed. For example, interest rate deregulation was first introduced in 1987. This deregulation continued until 1991 when interest rates were capped again at a maximum of 21% per annum for lending rate and minimum savings deposit rate at 13.5% per annum. In addition, banks were directed to limit their gross margin (the difference between the average cost of funds plus administrative expenses and the maximum permissible lending rate) to 4% (Ayogu, *et al* 1998). In 1992 interest rate caps were partially removed, but banks were encouraged to maintain a maximum spread of 5% between lending and deposit rates.

A similar pattern of inconsistency could be seen in the area of deregulation of entry into banking. Entry restrictions were first relaxed in 1987, leading to an extraordinary increase in the number of commercial and merchant banks from 41 in 1986 to 119 in 1991. The number of banks grew so dramatically that the government realized it was unhealthy to allow that rate of growth to continue. As a result the government temporarily placed an embargo on the licensing of new banks in 1991. This embargo was lifted in 1998 and consequently many more banks were licensed afterwards. The most recent attempt to deal with the expansion in bank numbers was in 2005, when the government increased the minimum capital requirement for banks from N2 billion to N25 billion. This substantial increase was a deliberate measure to encourage banks to merge, thereby reducing the number of banks in operation.

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Opposition to the SAP from the Nigerian public, including an attempt by the military to overthrow the government of General Babangida, helped to weaken the government's resolve to implement the reform package accordingly. However, while some aspects of the banking sector reforms continued, especially the private ownership of commercial banks, government alternated from interest rate regulation to deregulation and vice versa. This process means that SAP, including financial liberalization, was not implemented as designed, as government merely adopted aspects of the package that were expedient or effective at a point in time. Major policy reversals occurred in 1994 because according to officials of the CBN, the reforms were not working according to expectations (IMF, 1997). In 1994 the government suspended the issuing of new bank licenses. It also pegged the exchange rate of the Naira, regulated deposit and lending rates, and reintroduced aggregate domestic credit limits (Ayogu, Emenuga and Soludo, 1998). These measures were later reversed beginning in 1996.

The purpose of this chapter is to assess the impacts of the financial liberalization episode in Nigeria that started in the late 1980s. While the primary focus of analysis is on the effects of financial liberalization on Nigeria's financial sector, the chapter also reviews the impacts of liberalization on the emergence of new elites in Nigeria and their implications for public policy. This latter objective has often been overlooked by previous studies. The rest of the chapter proceeds as follow: Section 2 provides a description of data and methodology. Research results are discussed in section 3. Section 4 highlights the role of financial liberalization in the emergence of new elites in Nigeria, and concluding remarks are provided in section 5.

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6.2. Data and Methodology

To assess the effects of financial liberalization on Nigeria's financial sector, this chapter uses quantitative and qualitative data to measures changes in banking sector performance indicators before and during the period of financial liberalization. This chapter evaluates changes in the following indicators within the Nigerian banking sector:

(a) The number and geographical spread of banking institutions in Nigeria and its impacts on the availability of banking services in rural and urban areas.

(b) Efficiency in financial intermediation, measured by the spread between lending and deposit rates.

(c) The extent of savings mobilization, measured by gross domestic savings as a share of GDP.

(d) The extent of credit availability to the private sector, measured by total domestic credit to the private sector by commercial banks as a share of GDP, and

(e) Overall strength and stability of the banking sector, measured by the number of bank failures in Nigeria.

Besides availability of data, these indicators have been chosen on the basis of previous theoretical and empirical works as highlighted in the previous chapter. Ajakaiye (2002), Reinhart and Tokatlidis (2003), Nissanke and Aryeetey (1998) and others use similar measures to evaluate the effects of financial liberalization in various countries. If financial liberalization had positive impacts on financial sector development in Nigeria,

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one should see significant improvement in these measures of financial sector development during the reform period.

In addition to the indicators highlighted above, this chapter seeks to explore the extent to which financial liberalization altered the balance of economic and political powers in Nigeria. This connection has been noted in Auerbach (2001) who argues that private ownership of banks in Mexico helped to bolster the economic power of bankers, and these bankers later began to wield significant economic and political influence in the country.

The methodology includes quantitative and qualitative analyses of trends in Nigeria's financial sector prior to and during the period of financial liberalization. The quantitative component involves an analysis of financial development indicators using descriptive statistics. The qualitative analysis seeks to uncover important political, social, and economic factors in the liberalization process and outcomes in Nigeria. As Bates, *et al* (2000) noted, a good qualitative narrative takes into account the crucial importance of domestic interest groups, political regimes, external forces, and other relevant institutions in analyzing the process and outcome of reforms. This study explores the extent to which these factors influenced financial liberalization in Nigeria. Therefore, in addition to the stylized evidence presented in the quantitative data, this chapter seeks to uncover the "facts behind the figures", by providing qualitative analysis and explanation of the outcome of liberalization in Nigeria.

Quantitative data is collected from various Annual Reports and Accounts, and statistical bulletins of the Central Bank of Nigeria (CBN), World Bank *World Development Indicators*, and annual reports of various commercial banks in Nigeria.

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Data on banking sector distress is collected from *Annual Reports and Statement of Accounts* of Nigeria Deposit Insurance Corporation (NDIC). Where available, data are collected for the period 1975 to 2004.[2] Qualitative data are obtained from policy documents at the CBN and the Federal Ministry of Finance, IMF/World Bank publications and other reports, and studies. Data from these sources are supplemented by interviews conducted by the researcher in Nigeria in the fall of 2005.

One challenge with this study is the level of accuracy and validity of quantitative data, especially those obtained from Nigeria. While some variables such as the number of banks, bank failures, or the level of deposit and lending rates are likely to be accurate in most cases, data on other variables such as bank profitability may not be entirely reliable. In order to mitigate this problem, this study draws on evidence from various sources, including the IMF and World Bank, as well as from key informant interviews with government officials, bankers, businesspeople and trade associations.

6.3. Analysis of Empirical Results

Number and Geographic Spread of Banks

As stated in Chapter 4, European banks dominated the Nigerian banking sector during the colonial period. As Brownbridge (1998) notes, the domination of the Nigerian banking sector by foreign banks during the colonial period engendered resentment by Nigerians who felt that the expatriate banks had no intention of extending financial services to local businesses. Therefore, the immediate response of Nigeria and other African countries following political independence was to secure effective control of

[2] Qualitative discussions include changes up to 2006.

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their respective financial sectors, and to ensure improved access to financial services by local businesses.

The setting up of the Central Bank of Nigeria in 1959 marked the beginning of a new era in the Nigerian financial sector because the CBN was expected to lay the foundation for financial sector growth directed by Nigerians for Nigerians (Nwankwo, 1980). Between 1959 and 1962 eight new commercial banks were established in the country. According to Nwankwo, the boom in the number of new banks during the first two years of independence was partly due to an increase in the number of trading partners, as Nigeria was no longer restricted to trading with countries in the Sterling area, and partly due to the discovery of oil in commercial quantities, which attracted many multinational companies to the region. By the mid-1970s, the Federal Government and every state government in Nigeria had interests in one or more commercial and merchant banks (Brownbridge, 1998). The commercial banks were designed to provide both retail and wholesale banking services, while the merchant banks were wholesale banks providing services mainly to corporate clients, before they were abolished in the year 2000.

An immediate result of financial liberalization was a phenomenal increase in the number of banks and other financial institutions in Nigeria. In 1986, there were 29 commercial banks and 12 merchant banks in the country. At that time, three large banks dominated the banking industry.[3] The three big banks (and other smaller ones that were in existence prior to 1986) are commonly referred to as the "*first generation banks*" because they had been in operation for many years prior to the reforms. With the

[3] The three largest banks were First Bank, Union Bank, and United Bank for Africa

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relaxation of entry restrictions, 9 new banks were licensed in 1987, 16 in 1988, and by 1992, there were 66 commercial banks and 54 merchant banks in Nigeria.

Table 6.1
Number of Banks in Nigeria, 1980 – 2003

Year	Commercial banks		Merchant banks*		Total No. of Banks
	No. of Banks	No. of Branches	No. of Banks	No. of Branches	
1980	20	740	6	12	26
1981	20	869	6	15	26
1982	22	991	8	19	30
1983	25	1108	10	24	35
1984	27	1249	11	25	38
1985	28	1297	12	26	40
1986	29	1367	12	27	41
1987	34	1483	16	33	50
1988	42	1665	24	46	66
1989	47	1855	34	54	81
1990	58	1937	48	74	106
1991	65	2023	54	84	119
1992	66	2275	54	116	120
1993	66	2258	54	124	120
1994	65	2403	51	144	116
1995	64	2368	51	144	115
1996	64	2407	51	147	115
1997	64	2330	51	147	115
1998	51	2107	38	113	89
1999	57	2234	33	110	90
2000	90	2234	34	194	124
2001	90	3247	-	-	90
2002	90	3247	-	-	90
2003	89	3010	-	-	89

Source: Nigeria: *Major Economic, Financial and Banking Indicators*; Central Bank of Nigeria, 2004
* Universal banking was introduced in 2000 and merchant banking was abolished

As shown in Table 6.1 above, growth in the number of bank branches in Nigeria was not commensurate with growth in the number of banks. Between 1986 and 1990, the total number of banks increased from 41 to 106, an increase of 158.5%. During the same period the total number of bank branches grew from 1394 to 2011, an increase of 44%. One would observe that although the number of banks increased significantly, the

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number of service outlets (bank branches) did not keep pace with that increase. The reason for the wide disparity is that some of the newly licensed banks concentrated operations in the big commercial centers. Indeed, results of interviews with bank officials reveal that some of the new banks set up in the late 1980s and early 1990s were not particularly interested in traditional banking but focused almost entirely on foreign exchange arbitraging.[4] Foreign exchange trading offered almost a risk-free return to banks because of the spread between the official exchange rate and the parallel market rate existing at that time. According to Lewis and Stein (1997), the existence of multiple exchange rates in Nigeria made it possible for many of the new banks to focus almost exclusively on exploiting the arbitrage opportunities offered by the multiple foreign exchange markets.

The arbitrage opportunities in the foreign exchange market and the deregulated entry for new banks produced a high level of investor interest in the sector. By 1989 investors were divesting from other sectors and moving into banking. The process and criteria for obtaining a banking license was neither based on the competence of the directors or promoters of the new bank, nor on the strength of the business plan. Instead licensing appeared to be based primarily on the political and military connections of applicants for bank license. Interviews with officials of the CBN and the Federal Ministry of Finance point to the overwhelming influence of the Office of the Head of State in the licensing process.

[4] The foreign exchange market consisted of the official market through the CBN, and an unregulated informal market, described as the black market. Many banks were involved in round tripping, whereby the banks provide false records to the CBN and acquired foreign exchange at the official intervention rate, only to resell the foreign currency in the parallel market, making huge spreads.

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Similar to the results in Lewis and Stein (2002), interview respondents note that obtaining a bank license was based on the applicant's political connections as the Office of the Head of State was directly involved in reviewing and approving all applications. The involvement of senior military personnel and politicians in processing new bank licenses is apparent in the number of retired military personnel and their families on the board of many of the new banks. An examination of the *Nigeria Finance Yearbook* (1994) shows that there were 61 retired military officers in the boards of 95 financial institutions. Also, it was reported that the military Head of State for much of the reform period, General Babangida, has interests in at least three banks through various intermediaries. See, "Babangida (Nigeria) Limited", (*Tell* magazine, October 13, 1993, p. 11).

Some of the new banks that were interested in doing conventional banking introduced innovations like relationship banking, which entails developing closer business relationships with clients. In the process, they provided better customer services to clients. These banks, most of them managed by young managers, started a culture of good customer service in a sector that was hitherto characterized by gross inefficiency and poor quality service. The new banks also introduced the use of modern technology (mainly banking software) in the banking industry. As late as 1988, Nigerian banks were using manual ledgers to keep customers' records. This system of record keeping led to long queues in banking halls. Customers had to wait for several hours or even days to make a simple deposit or withdrawal from the banks. In some cases, a customer could only obtain prompt service if he knew a senior officer of the bank or if he offered money to an officer. Advances in technology globally and the prevalence of younger managers

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in the majority of the new banks made it trendy for these banks to invest in technology.[5] Recently, Ehikhamenor (2003) reported that almost all the banks in Nigeria have information technology policy in place although the extent of successful implementation of the policy varies from one bank to another.

Growth in the number of banks provided plum jobs for professionals and fresh university graduates. The industry attracted a large number of energetic young men and women, and getting a job in one of the *new generation* banks was akin to winning the lottery. These young and mostly inexperienced officers rose through the ranks quickly and often assumed leading positions in the banks (Lewis and Stein, 2002). In addition, the new banks lured staff away from government agencies, including the CBN. Overall, the level of professionalism in the industry remained poor, as the principal focus of many banks was simply to make huge profits irrespective of the type of business being done. This mindset coupled with poor management facilitated "fraudulent practices on the part of management and staff of some banks" (NDIC, 1991 p. 20).

The large increase in the number of banks reported in Table 6.1 does not include thousands of non-bank financial institutions (NBFI) that were set up during the same period. Almost all the new banks established at least one NBFI as a subsidiary. A NBFI was a tool for commercial and merchant banks to strategically circumvent rules and prudential guidelines set by the regulatory authorities. This avoidance of certain regulations arose because the NBFIs could participate (lend and borrow) in the inter-bank

[5] It is pertinent to note that Nigerian banks still lag behind in the area of technology when compared to what obtains in advanced economies. However, during liberalization the industry made significant improvement in the area of technology compared to the pre-liberalization era.

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market[6], but were not subject to the same regulations as banks (CBN, 1992). For example, while banks were expected to observe prudential guidelines such as respecting the rules on single obligor limits,[7] the NBFIs were not expected to observe such regulations. It was therefore convenient for some banks to have one or more NBFIs and use these institutions as cover to circumvent prudential regulations.

In general, the observed growth in the number of banks was driven mainly by the quest by investors and politicians to take advantage of the profit opportunities presented in the financial sector. The discontinuation of commodity subsidies, directed credit, and import licensing following the initial implementation of the SAP also closed these traditional avenues for rents, making it necessary for politicians and senior military officers to seek other avenues for making money (Lewis and Stein, 2002). Bank ownership became handy at that point. As stated above, many of the new banks were banks in name only, as they focused mainly on seeking arbitrage opportunities provided by the dual foreign exchange market at that time.

It is difficult to ascertain the exact number of banks that concentrated on foreign exchange arbitraging. Other studies including Ayogu, Emenuga and Soludo (1998), Brownbridge (1998), Lewis and Stein (2002), also report that many of the banks focused on taking advantage of the arbitrage opportunities in the foreign exchange market. The new banks that were interested in doing conventional intermediation introduced modern technology into banking in Nigeria, leading to important gains in service quality.

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[6] The inter-bank market is the market for funds were banks and non-bank financial institutions borrow and lend short-term funds from one another.

[7] The "single obligor limit" stipulates the maximum percentage of a bank's loan and advances that can be lent to a single borrower.

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Efficiency in Financial Intermediation

Financial liberalization theory suggests that an increase in the number of banks should lead to enhanced competition amongst banks. As competition intensifies, banks would need to be more efficient and reduce their lending rates and raise their deposit rates in order to attract and retain clients. Therefore, growth in the number of banks should result in improvements in intermediation efficiency.[8] There are important assumptions underlying the expectation that more banks should lead to more competition; and more competition should result to more efficient financial intermediation. First, this proposition assumes that the banks can indeed compete in the market for customers, i.e., each bank has the capacity (financial and technical) to compete in the financial market. Second, it also assumes that competition among banks would be fair, with adequate regulations and enforcement to deter unfair competition. Third, the proposition assumes perfect information such that bank customers have relevant information about the activities of one and every bank. When these assumptions do not hold, the presence of more banks may not result in more efficient intermediation. Table 6.2 presents the trend in deposit and lending rates in Nigeria from 1975 to 2004.

[8] The efficiency of financial intermediation is measured by the spread between lending and deposit rates. Low spread indicates efficient financial intermediation and high spread indicates inefficient intermediation.

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Table 6.2
Spread Between Lending and Deposit Rates in Commercial Banks

Year	Deposit rate	Lending rate	Spread
1975	3.00	6.25	3.25
1976	2.67	6.50	3.83
1977	2.83	6.00	3.17
1978	4.15	6.75	2.60
1979	4.47	7.79	3.32
1980	5.27	8.43	3.17
1981	5.72	8.92	3.20
1982	7.60	9.54	1.94
1983	7.41	9.98	2.57
1984	8.25	10.24	1.99
1985	9.12	9.43	0.32
1986	9.24	9.96	0.72
1987	13.09	13.96	0.87
1988	12.95	16.62	3.67
1989	14.68	20.44	5.77
1990	19.78	25.30	5.52
1991	14.92	20.04	5.13
1992	18.04	24.76	6.72
1993	23.24	31.65	8.41
1994	13.09	20.48	7.39
1995	13.53	20.23	6.70
1996	13.06	19.84	6.78
1997	7.17	17.80	10.63
1998	10.11	18.18	8.08
1999	12.81	20.29	7.48
2000	11.69	21.27	9.58
2001	15.26	23.44	8.18
2002	16.67	24.77	8.10
2003	14.22	20.71	6.50
2004	13.70	19.18	5.48

Averages Spread

1975 – 1986 2.51%
1987 – 2004 6.72%
Source: *World Development Indicators*

In the preceding section, I noted that some of the new banks achieved relative operational efficiency due to improvements in technology. However, this operational

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efficiency did not translate to industry-wide efficiency in financial intermediation. As shown in the table above, the spread between lending and deposit rates widened during the period of financial liberalization. The average spread rate for the period 1975 - 1986 was 2.51% compared to 6.72% for the period 1987 – 2004. It is pertinent to note that some form of controls over interest rates were in place in 1991 – 1992, and 1995 – 1996. However, the average spread during this 4-year period of re-regulation was 6.33% (which is higher than the average spread of 2.51% during the pre-liberalization period), and the average spread in years when interest rates were liberalized was 7.28%. Why would the large increase in the number of banks in Nigeria not lead to a reduction in the spread between lending and deposit rates?

First, there was no real competition among banks. The new banks such as Guaranty Trust Bank, Zenith Bank, Diamond Bank, Citizens Bank and others that focused more on conventional intermediation were content with serving only a niche clientele. For example, while a customer could open an account with as little as N200 (about $2) with any of the old generation banks, the minimum amount needed to open account with majority of the new banks ranged from about N250,000 to N500,000 ($2,500 to $5,000). The upper middle class clients who patronized the new banks were attracted by the relatively good quality of service offered by these banks and these patrons were prepared to pay a premium for that service. On the other hand, the older banks were willing to take on any customer. However, the quality of services provided by the old banks remained poor, and there was no serious competition between the old banks (Brownbridge, 1998).

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In addition, the new banks did not have the financial muscle to effectively compete with the large *old generation* banks. Although the number of banks increased dramatically, the structure of the banking sector remained largely oligopolistic. According to CBN (2004), 10 banks out of the 89 banks in operation in 2003 accounted for 51.9% of total assets, 55.4% of deposit liabilities and 42.8% of total credit in the banking system. This means that although they were many banks, only a few accounted for most of the formal banking activities in the country. The implication is that the volume and depth of banking services would not be significantly different if there were fewer banks. This structure also indicates a lack of effective competition among the banks, especially as the banks operated in segmented markets where some focused more on serving a niche clientele than others. The lack of market concentration in the Nigerian banking sector is noted in Agusto (2005) who show that the Herfindahl-Hisrchman index of the Nigerian banking industry reflects a lack of concentration during the past several years.[9]

Second, in order for competition to have a significant impact on lending rates, bank customers must have perfect information about the lending rates of every bank, and customers must be able to process and act on this information accordingly. In other words, a bank borrower should be able to transfer his business from a bank charging high interest rate to a bank that offers lower rates. Where there is imperfect information, banks may charge widely different lending rates without the risk of losing clients. In such a situation, the spread between lending and deposit rates may remain high. As Stiglitz and

[9] The Herfindahl-Hisrchman index (HH) is a standard measure of concentration in an industry. An index less than 1000 implies the industry is not concentrated.

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Weiss (1981) demonstrate, imperfect information could lead to a fragmented credit market and may result to credit rationing.[10]

Until recently, the structure of banking in Nigeria was such that branches of the same bank could charge widely different rates without the risk of losing customers. This ability was due to weak and underdeveloped communication and information technology. Bank customers did not have up-to-date information on the rates charged by banks within the major commercial city of Lagos. It was also impossible for customers in other cities to have perfect information on what was going on in other banks in different cities, or even if they did it would be difficult to exploit these due to limitations in transportation and communication. The cost of accessing banks with better rates may well have exceeded the benefits those rates would confer.

Furthermore, customer loyalty built over many decades of business relationships with the older banks, as well as feelings of doubts about the strength and continuity of the new banks, meant that some clients maintained banking relationship with the old banks irrespective of differences (if any) in lending rate in the old and the new banks. Similarly, some bank customers preferred to do business with the new and more innovative banks that were prepared to take on more risks. In a regime of liberalized interest rates, higher risks would necessitate higher lending rates, and this would mean a higher spread. Commenting on Nigeria's banking industry in the 1990s, a staff member of one of the post-liberalization banks noted as follows: "some older businesspeople would not do business with us irrespective of what we offered; there was this suspicion that the new banks would not be around for long". In effect, some bank customers who had the financial resources to open accounts with one of the new banks were content in dealing

[10] This is further explored in the sub-section on credit supply.

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with the older banks irrespective of the lending rates being charged by the old banks. This form of loyalty was strengthened in part by a lack of confidence in the survival and continuity of the new banks.

In addition, banks could maintain high spreads between lending and deposit rates because of the desperation of firms and households wishing to gain access to the formal credit market. In general, the average small business owner in Nigeria has no access to bank credit of any form.[11] Similarly, besides the very exclusive class of individuals with enormous wealth, consumer credit is non-existent, as working class households have no access to bank credit. Given this situation, banks that were willing to lend could simply rely on the basic rules of demand and supply to extract enormous rents from borrowing clients, who would otherwise have recourse only to the informal credit market where interest rates could be as high as 120% or more per year.[12]

In terms of the spread between lending and deposit rates, banking sector reforms in Nigeria did not lead to efficient financial intermediation, as the average spread increased during the reform period. This result confirms the findings in Brownbridge and Harvey (1998) and those of Ajakaiye (2002), who noted that instead of enhancing efficiency in intermediation, the liberalization of interest rates created the opportunity for operators to extract rents from the system. In exploring why liberalization did not enhance intermediation efficiency in Nigeria, this study arrives at the following explanations: the increase in the number of banks did not significantly alter the

[11] Apparently in response to this fact, the CBN recently mandated banks to allocate 10% of profit after tax to the Small and Medium Enterprises Equity Investment Fund (CBN, 2005). Although banks are making this contribution, access to the fund remains highly restricted to a few businesses because of stringent eligibility requirements.

[12] In 2005, few commercial banks introduced consumer credit products to the market. Interview respondents note that these consumer credit products remain restricted to rich individuals.

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oligopolistic structure of the Nigerian banking industry, as only a few banks continued to dominate the market. The large banks were not in competition with one another, and the new ones could not compete with the older ones because of differences in financial strength. Customer loyalty enjoyed by the old banks, lack of confidence by some bank customers in the survival and continuity of the new banks, as well as imperfect information in the banking market made it possible for banks to maintain wide spreads.

In addition, lack of access to credit facilities by many Nigerians made it possible for the banks (those willing to lend to customers) to charge high lending rates because the demand for credit was more than the supply. In effect, the market remained segmented between the established banks and their traditional customers on the one hand, and newer banks and new customers on the other. The excess demand for banking services that had previously been rationed out of the market by regulation exclusion rather than price suddenly emerged in the form of wide interest rate spreads. In fact, the spread between lending and deposit rates increased during the reform period because with the deregulation of interest rates banks could charge higher rate on loans and pay marginal rates on deposits. The emergence of these dramatic spreads would not have been possible when the government determined deposit and lending rates. [13]

Domestic Savings

In developing countries like Nigeria, bank savings is a principal means of providing for one's present and future needs. Since business credit is hard to come by and

[13] There is the potential argument that the liberalization of interest rates led to increasing spread between lending and savings rates, which in turn led to higher bank profit and thus encouraged the entry of new banks in Nigeria. For example, the correlation between the number of banks and interest rate spread was 0.835, indicating strong positive relationship between the two. However, this positive relationship undermines the assumption that the entry of more banks would engender competition and reduce the spread.

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consumer credit is almost non-existent, individuals and households have to keep cash in savings so as to provide for themselves and their extended families in times of need. Unlike developed economies such as Canada, there are no social programs such as universal healthcare, child benefits or any form of welfare benefits to Nigerians. Therefore, Nigerians have more need for precautionary savings than do people from countries where there is government support systems. It is therefore common for savings rates in a country like Nigeria to be much higher than those of Canadians or other developed economies, despite average household incomes being higher in the latter. Similarly, the existence of well functioning capital markets and other investment outlets such as mortgages makes it less attractive for households in developed countries to keep huge sums of money in a regular savings account. In addition, in Nigeria, public funds sometimes end up in private savings accounts, and corrupt officials generally prefer to keep proceeds of illicit activity in liquid form so they can flee the country with ease should the need arise.

Table 6.3 below presents data on domestic savings as a percentage of GDP in Nigeria from 1975 to 2004. One obvious observation from the data (obtained from the World Bank's *World Development Indicators*) is a high level of volatility in the volume of savings as percentage of GDP. While I do not rule out the probability of measurement error, there are plausible explanations for the high variation in the savings rate. First, Nigeria's major source of revenue is the sale of oil in the international market. Volatility in the oil market means volatility in all economic indices in Nigeria. For example, the years with the lowest level of savings in the (1982 – 1988) also coincided with the period of oil glut that resulted in reduced revenues for the Nigerian Government. It is not

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unusual for heads of government departments to transfer public money into private savings account where they earn huge sums of money in interest payments. The "benevolent" ones may return the principal sum later to government coffers for onward spending. This process contributes to the volatility in savings rate.

Between 1987 (when interest rates were formally liberalized) and 2004, Nigeria had positive real deposit rate for only seven years (1987 1990, 1991, 1999, 2000, 2002, and 2003). This pattern was probably due to the inconsistent pattern of implementing the reforms. Given that the government alternated from a regime of interest rate controls to that of deregulation and then back to controlled rates, and given conflicting fiscal policies where the government reduced public spending in one quarter and increased it in the next, it was difficult to have consistent pattern of real rates.

As shown in Table 6.3, the real deposit rate was largely negative during the era of financial repression, but was occasionally positive during the reform period. However, on the average, the volume of domestic savings as a percentage of GDP grew from 19.96% during the pre-reform period (1975 – 1986) to 25.94% during the reform period. The average savings as a percentage of GDP was (26.54%) during the years in which government reinstated controls and/or ceilings on interest rates (1991 –1992 and 1995 – 1996). This level of savings was higher than the average for the pre-liberalization period (19.96%).

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Table 6.3
Savings Statistics, 1975 to 2004

Year	Deposit Rate	Inflation rate (annual %)	Real Deposit rate	Savings (% GDP)
1975	3.00	33.96	-30.96	20.74
1976	2.67	24.30	-21.63	25.77
1977	2.83	15.09	-12.25	30.68
1978	4.15	21.71	-17.56	23.32
1979	4.47	11.71	-7.24	27.84
1980	5.27	9.97	-4.71	31.43
1981	5.72	20.81	-15.10	19.23
1982	7.60	7.70	-0.10	14.04
1983	7.41	23.21	-15.80	10.83
1984	8.25	17.82	-9.57	11.42
1985	9.12	7.44	1.68	12.63
1986	9.24	5.72	3.52	11.63
1987	13.09	11.29	1.80	19.92
1988	12.95	54.51	-41.56	19.10
1989	14.68	50.47	-35.79	25.26
1990	19.78	7.36	12.42	29.36
1991	14.92	13.01	1.91	29.31
1992	18.04	44.59	-26.55	23.54
1993	23.24	57.17	-33.92	20.21
1994	13.09	57.03	-43.94	20.63
1995	13.53	72.81	-59.28	18.44
1996	13.06	29.29	-16.23	34.87
1997	7.17	8.21	-1.04	24.65
1998	10.11	10.32	-0.21	19.57
1999	12.81	4.76	8.05	19.15
2000	11.69	8.98	2.71	33.43
2001	15.26	18.79	-3.53	31.66
2002	16.67	13.02	3.65	25.83
2003	14.22	14.05	0.17	32.35
2004	13.70	15.01	-1.31	39.72

Average domestic savings (% of GDP)
1975 – 1986 19.96
1987 – 2004 25.94
Source: *World Development Indicators*

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As Table 6.3 shows, the volume of savings as percentage of GDP increased on average during the reform period despite the existence of a negative real deposit rate. It is therefore safe to conclude that the increase in savings was not a result of a positive real deposit rate. Why did savings levels increase on average during the reform period despite the prevalence of negative real rates? Most of the major increases in savings occurred in years when the international oil market was favourable to oil exporting countries. For example, the U.S Gulf war in 1990 sent oil prices up, with the result that oil revenue accruing to the Nigerian Government increased. Also, the high price of crude oil experienced in the last few years has boosted Nigeria's oil revenue. In Nigeria, high revenue for the government almost always translates into more money for political office holders and their cronies.[14] This pattern occurs because public spending tends to find its way back to the pockets of government contractors, the military, and their cronies without corresponding public production. The increase in the volume of savings may therefore be a result of improved revenue receipts that arise from increases in oil price.

Furthermore, the establishment of the Community Banking Scheme in 1990 helped to generate a lot of deposits by mopping up household savings that were outside of the banking system. The community bank is a self-sustaining financial institution owned and managed by a community or a group within the community. The role of community banks in Nigeria is to provide banking services to the community where it is located. Community banks were designed to fill the gap created by the selective service provision of the commercial and merchant banks. Whereas most commercial and merchant banks are concentrated in the major cities and provided banking services in the

[14] Although some of the looters of the state treasury keep their loot in foreign banks, they also maintain reasonable sums of money in local banks.

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urban areas, the community banks provided banking services to the local community (Marx, 2004). Community banks were important tools in mobilizing savings from small savers. The first community bank was opened in the city of Kaduna in 1990, and by the end of 1995 the National Board for Community Banks (NBCB) had issued 1,355 community banking licenses. According to Marx total deposits held by community banks in Nigeria was about N20 billion by the year 2000. Although this amount is not a large percentage of the GDP, it did enhance the volume savings in the system.

In addition to the role of community banks, some of the new banks facilitated the growth of savings by introducing new and sometimes exotic savings products to attract depositors' funds. Unlike in the pre-reform years when there was no dynamism in banking, some of the new banks introduced savings products that offered various gifts and prizes to depositors. Commenting on the success of some of the new banking products introduced into the market, Dr. Erastus Akingbola, CEO of Intercontinental Bank Plc (one of the successful new generation banks) noted as follows: "...I'm sure we have over six now. There is the IDF, there is ICash, there is ILead, there is IVY Account, and there is IPSA and IClass. The products have performed very well in the market. The IDF as you know has been a leading product in the banking industry...and we have over N5 billion in that particular product."[15] Because they offer various incentives to customers, these and similar products have been used by some of the new banks to encourage depositors to save more in the bank.

Apart from the new products, some of the new generation banks started a culture of good customer service. This is in contrast to what obtained in the pre-reform days

[15] See "Place of team work in our success story – Dr. Erastus Akingbola, Vice Chairman/Chief Executive of Intercontinental Bank", *Daily Sun*, May 17, 2004

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where bankers behaved as if it was a privilege for one to have access to banking services. Bank clients were impressed with the dramatic change in service culture as the new banks introduced elements of relationship banking where bank officials sometimes provided personalized services to customers. This type of service was a big contrast to what obtained in the pre-1986 periods where bankers neither cared about service quality nor about profitability. All the business people interviewed in Lagos confirmed there has been a significant improvement in the quality of service provided by the surviving banks; and one business owner noted that he was pleasantly surprised when a new generation bank offered to go to his place of business to pick up his sales collections for deposit in the bank. On the other hand, during the era of financial repression, bank customers usually spent long hours at the bank in order to conduct simple banking transactions like depositing or withdrawing money.

It seems that high nominal deposit rates combined with factors such as the introduction of community banks, new product development by the new banks, and improvements in relationship banking and service quality made it attractive for bank clients to increase the use of banking services. It would appear that many depositors were either ignorant of the impact of inflation on the real deposit rate, or had no alternative product or investment outlet that would provide a hedge against inflation. Also, the rising price of crude oil in the international market in the last few years has led to increases in Nigeria's revenue. This increase has also affected the volume of savings in the system.

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Domestic Credit to the Private Sector

The financial liberalization framework suggests that the volume of bank credit in the economy should also rise following the deregulation of the banking sector, as households save more money that can be distributed, and banks compete to attract and retain clients. Although the number of banks increased in Nigeria, banking system credit to the non-bank private sector as a percentage of GDP declined on average during the reform period. As shown in Table 5.4 below, average private sector credit as a percentage of GDP fell from 13.46% during the pre-reform period (1975 – 1986) to 12.35% during the period 1987 – 2004.

Several reasons account for the decrease in the volume of credit during the reform period. First, the existence of a dual foreign exchange market provided incentives for banks to avoid the credit market. By 1989 many of the banks, especially the new ones had realized that trading in foreign currency provided higher rates of returns at less risk. This realization led to increased activities in the foreign exchange market, and less interest in lending. As Brownbridge (1998) observed, "...the reforms of the foreign exchange market ... provided a strong incentive for private investors to set up banks, not to conduct conventional banking business but to obtain access to foreign exchange at preferential rates" (p. 123).

Secondly, with the removal of mandatory credit allocation guidelines, banks had the freedom to decide how to use deposit liabilities. Bank management could decide to participate in the credit market or to invest the bank's fund in other areas. Unlike the era of government controls, where banks were mandated to lend a specified proportion of total assets to select priority sectors, financial liberalization gave banks the power to

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decide whether to lend to any sector or to stay away from the credit market altogether. Bankers noted that liberalization afforded bank management the opportunity to stay away from lending to sectors that were considered too risky. For example, many banks stayed away from the agricultural sector when mandatory lending to that sector was abolished.[16]

Increased inter-bank lending also contributed to the low level of credit to the non-bank private sector. Inter-bank lending reached unprecedented levels following the entry of several non-bank financial institutions (NBFIs) into the financial market. Banks were more comfortable lending to other banks and NBFIs in the inter-bank market than lending to individuals and business in the traditional credit market. This preference for inter-bank lending was because many banks had NBFIs subsidiaries and the banks used these subsidiaries as avenue to distribute unmonitored advances to its directors and senior management. As noted in Lewis and Stein (2002), "by reshuffling funds and extending unmonitored credit, the NBFIs permitted banks to evade regulation in lending, interest rates and capital structure, and few banks operated without such affiliates" (p. 28). Banks found in NBFIs a useful tool for evading prudential regulations. Almost all the new banks had interests directly or indirectly in one or more NBFI.[17]

[16] This was confirmed in interviews with bankers and members of the Chamber of Commerce.
[17] The *Nigeria Finance Yearbook* (1994) reports 310 interlocking directorates among banks, insurance companies and NBFIs as at 1993.

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Table 6.4 Bank Lending to the Private Sector (% of GDP)

Year	PC (%GDP)
1975	6.81
1976	7.62
1977	9.24
1978	10.99
1979	10.39
1980	12.23
1981	15.93
1982	18.51
1983	17.25
1984	16.34
1985	15.68
1986	20.54
1987	14.84
1988	13.18
1989	9.39
1990	9.41
1991	9.43
1992	12.03
1993	9.11
1994	11.49
1995	10.20
1996	8.93
1997	10.57
1998	12.94
1999	13.95
2000	13.61
2001	15.37
2002	16.56
2003	15.73
2004	15.63

Averages

1975 – 1986 13.46%
1987 – 2004 12.35%
Source: *World Development Indicators*

As shown in the above table, the period 1989 to 1997 witnessed the lowest level of credit to the private sector as a proportion of GDP. This was the period of the most distressing turbulence in the financial sector. As signs of distress became apparent in the

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early 1990s, banks reduced lending because the atmosphere was tense and no one knew the magnitude of the impending banking crisis. Many banks lost huge amounts due to the failure of several NBFIs during the period 1990 to 1994. For example, the proportion of bad loans and advances to total loans and advances in Nigerian banks was 44.1% in 1990 and 39% in 1991 (NDIC, 1991). As more financial institutions began to fail, bank management generally held back on lending to wait for a more stable operating environment. When the NDIC began to liquidate failing financial institutions in the late 1990s, the banking industry became more stable and bank lending began to increase.

Much of the credit to the private sector was short-term in duration because banks avoided long-term projects. For example, the CBN reports that between 1989 and 1996, the percentage of credit maturing within 1 year was consistently above 82% (CBN, 2005). This dominance of short-term credit contrasts with what is observed in developed economies where medium and long-term credit could constitute more than 50% of total domestic credit in the economy. Similarly, in Botswana total credit maturing with 1 year was only 46.1% in 1995 (Harvey, 1998). It is interesting to note that much of the short-term loans in Nigeria was invested in the lucrative foreign exchange market for speculative purposes. Foreign exchange speculators needed to provide the local currency (naira) equivalent of the amount of foreign currency they wished to buy in the official market. Another factor that contributed to the short-term structure of the credit market was uncertainty about the direction and future stability of the banking system in general.

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Bank managers reasoned that long-term lending in the face of a general macroeconomic instability was a risky option that could lead to huge losses.[18]

Bank Failures

As shown in the previous chapter, studies such as Demirguc-Kunt and Degiatriache (1998), Weller (2001) and others have made the connection between financial liberalization and banking crises. These authors conclude that financial liberalization increases the likelihood of bank failures, and the probability of such bank failures is higher where financial liberalization is undertaken in an environment with weak institutions. One of the most glaring effects of financial liberalization in Nigeria is the distress that engulfed the country's banking sector in the mid-1990s. Only a few years after the relaxation of entry restrictions into the banking sector, many banks were technically distressed although they continued to operate. By 1994 the level of distress in the banking sector had reached such a level that, besides the three big banks, it was difficult to ascertain which bank was healthy and which was not. Depositors' confidence in the banking sector began to decrease as cases of banks reneging on maturing obligations became rampant.

It should be recalled that prior to 1989 there was no deposit insurance scheme in Nigeria. During this time, the full responsibility for bank supervision rested solely with the CBN. By 1990, the Nigerian Deposit Insurance Corporation (NDIC) was still in its first few months of operation, and by the time the Corporation began to define its mission and operating guidelines, the decay in the banking sector had already reached an

[18] Interviews with bankers in Nigeria reveal that banks are beginning to invest in medium to long-term projects following the just concluded consolidation in the banking sector. Bank managers believe the current environment is more stable and macroeconomic policies more coherent.

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advanced stage. The distress in the banking industry was not confined to a few fringe players, but reflected a systemic failure with implications for many banks, including the very big ones. The large commercial banks (old generation banks), although not distressed, were affected because of inter-bank dealings with the new banks. The older banks found inter-bank lending very lucrative because many of the new banks effectively relied on inter-bank money for survival. When the new banks were unable to honor inter-bank obligations, the older banks lost a large portion of assets tied to these banks.

The failure of National Bank of Nigeria, a relatively old commercial bank jointly owned by four south western states, was the first major bank failure known to the public. In 1992, National Bank was formally taken over by the CBN and the NDIC, while the process of liquidation was worked out. Over the succeeding years, bank failures became more rampant, as almost all the state-owned banks and many privately owned ones were taken over by the CBN and the NDIC. By 1995, the CBN and NDIC acknowledged that over half of the existing 115 banks were distressed (NDIC, 1995). The ones that were not redeemable were barred from parading as banks while the CBN/NDIC worked to liquidate the banks and pay the banks' depositors.

A major cause of bank failures in Nigeria was poor management. Prior to 1991, there were no specified minimum qualification in terms of education and experience needed to qualify as a Chief Executive of a bank. Owners of banks hired their cronies, or people from their ethnic group, into senior positions in the bank regardless of their management ability. It was therefore typical to have the senior management of a bank from the same ethnic group as the bank owner(s) (Lewis and Stein, 2002). This focus on ethnicity instead of merit posed serious problems for the quality of management. Besides

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the reliance on ethnicity in the selection of bank management, there was insufficient number of qualified professionals to manage the many banks in operation at that time. In the majority of the new banks, senior managers were young people, some of whom had only a few years of banking experience. Commenting on the quality of management in the banks, the NDIC notes as follows:

> Ineffective management continued to be one of the major reasons for financial distress, especially in those banks owned by State Governments. Some of these banks were characterised by inept management and instability in the tenure of office of key management staff...Negative culture of inter-personal wrangling among some banks' top management staff leading to polarization of the rank and file of staff persisted in 1991 (NDIC, 1991 p. 20).

Bank management also capitalized on a weak regulatory environment to engage in unprofessional practices. As bank managers became more focused on violating the rules and making money, terminologies such as *round-tripping*, *cheque-kitting*, *shadow-bidding*, *duplicate charges*, and *duplicate accounting* became commonplace in the industry.[19] Indeed it would appear that professional dexterity was measured by the sophistication with which a bank manager is able to circumvent the rules and acquires personal wealth as well as make money for the bank's directors. NDIC's examination of the banks revealed deliberate misrepresentation of material facts by bank management. According to the NDIC, "the most common anomalies found in the examined banks

[19] These were gathered from confidential interviews with officials of commercial banks who were in the system during the 1990s. *Round-tripping* denotes the fraudulent practice of buying foreign currency in the official market, selling it for local currency and re-using the local currency to buy more foreign currency, to repeat the process. *Cheque kitting* is a form of Ponzi scheme where banks and their clients issue dud cheques from one bank to cover an open (debit) position in another bank, doing the same with several banks. *Shadow bidding* denotes a situation where banks use non-existent customer names to bid for and obtain foreign currency at the official rate. *Duplicate charge* is a conscious fraud where a customer's account is debited more than once for the same transaction. There is *duplicate accounting* when a bank prepares more than one set of financial statements. One statement is for the consumption of directors, and the others are for regulatory authorities.

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included the following: improper loan documentation and window-dressing of non-performing credits which gave false impression of performance" (NDIC, 2001; p. 37).

Another factor that contributed to the failure of banks in Nigeria was capital inadequacy. One of the important roles of capital in a bank is to provide a cushion to absorb operating losses that may occur in any given year. Adequate capital is necessary to ensure the survival of a bank during good and bad business cycles. The NDIC noted that the "capital adequacy of a bank is generally gauged by the extent to which owners' funds provide cover for depositors in the event of loans and advances going bad" (NDIC, 1991; p. 21). Overall capital adequacy of Nigerian banks was below the required minimum by about N1.9 billion in 1991. The state-owned banks had the worst capital adequacy ratio, with the shortfall in the minimum capital requirement estimated at N2.2 billion in 1991 (NDIC, 1991).

The NDIC further reports that shareholders' funds in the state-owned banks were not sufficient to cover classified loans and advances in 1990 and 1991. With inadequate capital, slight changes in the operating environment could mean the failure of a bank. This was the case in 1989, when the Federal Government of Nigeria directed all government departments and agencies to withdraw public sector deposits from the commercial banks and place such funds with the central bank. The withdrawal of public sector deposits from commercial banks, coupled with inadequate capital in some of the banks, contributed to the failure of some banks.

Inadequate regulatory and supervisory capacities also contributed to the crisis in the Nigerian banking sector. Although the number of banks increased from 29 in 1986 to 58 in 1990, the number of bank examiners at the CBN remained about the same during

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the period. Interview respondents noted that the government did not anticipate the level and speed of growth in the number of banks following the deregulation of licensing of new banks. Consequently, the CBN was not prepared to handle the ensuing challenges generated by increased activities in the banking sector. The Nigeria Deposit Insurance Corporation (NDIC) established in 1989 was set up to complement CBN's supervisory role. The NDIC began operation with a crop of bank examiners hired from the CBN (NDIC, 1999). In effect, the presence of the NDIC did not immediately lead to an increase in the number of bank examiners available to supervise the banks. Although there were 65 banks in Nigeria as at 1991, the Examination Department of the NDIC carried out only 8 routine examinations of commercial and merchant banks during the year (NDIC, 1991). In addition, the NDIC noted that its regulators faced challenges in coping with new technologies in use in many of the new banks. According to the NDIC, the use of modern technology in the new banks poses "increasing challenges to regulators in terms of keeping abreast not only with the emerging financial products but also with practitioners' sharp practices . . ." (NDIC, 1999, p. 69).

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Table 6.5 Liquidated Banks in Nigeria, 1994 to 2002

S/No	Name of Bank	Date of Closure**
1	Abacus Merchant Bank	January 16, 1998
2	ABC Merchant Bank	January 16, 1998
3	Allied Bank of Nigeria Plc	January 16, 1998
4	Alpha Merchant Bank Plc	September 08, 1994
5	Amicable Bank of Nigeria Ltd	January 16, 1998
6	Century Merchant Bank Ltd	January 16, 1998
7	Commerce Bank Ltd	January 16, 1998
8	Commercial Trust Bank Ltd	January 16, 1998
9	Continental Merchant Bank Plc	January 16, 1998
10	Co-operative and Commerce Bank Plc	January 16, 1998
11	Credite Bank Nigeria Ltd	January 16, 1998
12	Crown Merchant Bank Ltd	January 16, 1998
13	Financial Merchant Bank Ltd	January 21, 1994
14	Great Merchant Bank Ltd	January 16, 1998
15	Group Merchant Bank Ltd	January 16, 1998
16	Highland Bank of Nigeria Plc	January 16, 1998
17	ICON Ltd (Merchant Bankers)	January 16, 1998
18	Ivory Merchant Bank Ltd	December 22, 2000
19	Kapital Merchant Bank Ltd	January 21, 1994
20	Lobi Bank of Nigeria Ltd	January 16, 1998
21	Mercantile Bank of Nigeria Plc	January 16, 1998
22	Merchant Bank of Africa Ltd	January 16, 1998
23	Nigeria Merchant Bank Ltd	January 16, 1998
24	North-South Bank Nigeria Plc	January 16, 1998
25	Pan African Bank Ltd	January 16, 1998
26	Peak Merchant Bank Limited*	February 28, 2003
27	Pinacle Commercial Bank Ltd	January 16, 1998
28	Premier Commercial Bank Ltd	December 22, 2000
29	Prime Merchant Bank Ltd	January 16, 1998
30	Progress Bank of Nigeria Plc	January 16, 1998
31	Republic Bank Ltd	June 29, 1995
32	Rims Merchant Bank Ltd*	December 22, 2000
33	Royal Merchant Bank Ltd	January 16, 1998
34	Savannah Bank of Nigeria Plc*	February 15, 2002
35	United Commercial Bank Ltd	September 8, 1994
36	Victory Merchant Bank Ltd	January 16, 1998

*Liquidation suspended following court action
** Represents date of official closure after completion of the liquidation process
Source: *NDIC 2004 Annual Reports and Accounts,* p. 49-50

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The NDIC reports that a total of N108.9 billion of depositors' funds was trapped in the failed banks as at 2004. Of the amount trapped in the failed banks, only N5.2 billion or 23.3% are insured under the deposit insurance scheme. The result is that many depositors have lost their funds and have lost confidence in the banking system as well. Similarly, total loans and leases of distressed banks was N191.94 billion or 16.5% of total loans and leases of all insured banks. Of the loans and leases of distressed banks, 79.2% are classified as non-performing (NDIC, 2004; p. 15). The failed banks remained in technical suspension for many years (with depositors' funds trapped therein). Between 1994 and 2002, the CBN successfully revoked 34 bank licenses, while cases for the liquidation of 3 more banks are being contested in various courts (NDIC, 2004).

Although many banks had started having financial difficulties before 1991, it was not until the promulgation of *Banks and Other Financial Institutions Decree* (BOFID) in 1991 and the establishment of Prudential Guidelines for licensed banks that the distress in the banking industry became obvious. BOFID specified rules for the establishment and operation of banks and other financial institution, and defined management and directors' responsibilities in ensuring compliance to applicable rules (BOFID, 1991). A simple prudential audit of Nigerian banks in 1990 would have revealed deep-rooted distress in the system, but fraudulent accounting, misleading reports, and the inability of authorities to discern good from bad reporting conveniently concealed the problems in the banks. Banks carried on business as usual until such a time when excessive greed and fraudulent repatriation of capital by bank owners made it difficult for some banks to honor maturing inter-bank obligations.

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The need to stabilize the banking industry following the phenomenal growth in the number of banks prompted the government to introduce new polices and operating guidelines for banks. These polices, important as there were, affected the banks adversely. The Implementation of the Prudential Guidelines for Licensed Banks[20] in 1990 made it possible for regulators to observe financial weaknesses in some of the banks. The banks had previously concealed these weaknesses through creative accounting and overt misrepresentation. Shortly after the introduction of the Prudential Guidelines, the CBN released another circular that stipulated guidelines for the revaluation of fixed assets of banks.[21] As the implementation of the new guidelines revealed weaknesses in some of the banks, discerning customers began to move away to safer alternatives. This loss of business aggravated the problems in the banks and contributed to the failure of many of them.

Another factor that contributed to the failure of many banks was the removal of government protection, especially on state-owned banks. State-owned banks such as the defunct Co-operative and Commerce Bank, Progress Bank, and Mercantile Bank that were under the direct control and protection of their respective state governments could not survive when government relinquished controls. Attempts to privatize some of the state-owned banks did not succeed because due diligence on them revealed the banks were insolvent.[22] Since private investors were not willing to take on banks whose financial health was questionable, the state government-owned banks were the first to fail. During the period of financial repression, the state governments controlled the banks,

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[20] The Prudential Guidelines stipulated how banks should recognize interest income, classify loans, and make provisions for doubtful loans and advances. See "Prudential Guidelines For Licensed Banks", CBN, 1990.
[21] See CBN Circular No. BSD/PS/23/Vol.1/15 of November 7, 1991
[22] This is based on interviews with officials of the NDIC.

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and bank managers extended loans to the government without proper credit appraisal. The NDIC reports that the proportion of bad loans and advances to total loans and advances in the state government-owned banks was 69% in 1990 and 66.3% in 1991. This is above the proportion of bad loans and advances in all other banks of 42.3% and 32.3% in 1990 and 1991 respectively (NDIC, 1991).

While it may be improper to dismiss financial liberalization as merely a precursor for bank failure[23], it is probably no coincidence that the distress in the Nigerian banking industry happened just as liberalization was going on. Interestingly, the previous major distress in Nigeria's banking industry occurred in the early 1950s during another period of "liberalization", where there were practically no rules for setting up and operating a bank. In 1952, long before the CBN was established, 10 banks were set up in an unregulated manner and all of them failed in 1954 (CBN, 1968). Since 1958, when the CBN Ordinance was promulgated and the Nigerian banking sector became more organized, the country had not seen the level of upheaval in the financial sector as it witnessed during the 1990s.

The expansion in the number and varieties of financial institutions and the mostly inconsistent government policies in the financial sector created opportunities for operators to abuse the system and convert liberalization to an instrument for legitimizing fraud and selfish accumulation. The unprofessional means of allocating bank licenses, the use of non-bank financial institutions as subsidiaries, the arbitrage opportunities offered by dual foreign exchange markets, the dearth of professionals in the commercial banking sector, the absence of adequate capacity for supervision and the lack of a coherent regime

[23] However, studies such as Demirguc-Kunt and Degiatriache (1998), Weller (2001) and others have established the connection between financial liberalization and banking crises.

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of regulation and supervision contributed to undermine any potential benefits of financial liberalization. These unhealthy characteristics combined with a deliberate desire of operators to circumvent rules and extract rents led to fraud and other financial crimes, and the consequent failure of many banks.

6.4. Financial Liberalization and the Emergence of a New Elite

Studies on the impacts of financial liberalization have often shied away from exploring the links between financial liberalization, rent creation and the balance of economic and political powers in developing countries. This lack of interest in exploring the effects of financial liberalization on rent seeking is perhaps reinforced by the assumption that liberal market policies would check rent-seeking and would not foster any form of rent collection or inefficient allocation. During the era of financial repression in Nigeria, government credit allocation, direct rationing of foreign exchange, government control over import licenses, and commodity subsidies created avenues for rents for government officials and their cronies. Economic liberalization under the SAP was meant to eliminate or at least reduce these avenues for official corruption and self-enrichment.

With the implementation of the SAP, many of the leading sources of rents for politician and senior government officers were discontinued. However, the licensing of new banks and government's foreign exchange policies provided an alternative avenue for private accumulation. Similarly, the removal of credit allocation guidelines for the new banks and a weak regulatory structure further made it easy for bank owners and management to commit and conceal fraud using their bank as cover. Financial

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liberalization in Nigeria did not eliminate rents through enhanced competition and free pricing, as predicted by the liberalization theory. To the contrary, the licensing of new banks created a new avenue for selfish accumulation, perhaps in a much larger proportion than during the days of financial repression.

Although official corruption and all forms of rents were already principal components of Nigeria's political economy prior to liberalization, government officials, senior military officers and politicians who have access to state resources largely perpetrated most of these nefarious activities. However, the liberalization of entry into the banking sector made it possible for private individuals to join the scramble for rent by setting up banks and other financial institutions that became instruments for financial speculation and covert fraud. Besides buying and selling foreign currency, some bank directors and managers acquired personal wealth through spurious insider loans that were never repaid to the banks. Bank directors borrowed money from the bank without adequate collateral and without the intension of paying back the amount borrowed. To underscore the magnitude of insider credit in some of the banks, one of the banks under liquidation was alleged to have granted about 70% of its total loans and advances to companies associated with its Chairman and principal shareholder.[24]

Next to holding political office, banking became the most lucrative venture attracting businessmen and military officers alike. Owners and managers made quick money, improving their social and economic status overnight. This situation contrasts with the era of financial repression where banking lacked dynamism and bank managers were no different from government employees. Financial liberalization generated

[24] See Tell magazine of October 10, 2005. Available on http://www.tellng.com/news/articles/051028-1/news/biz_battle.htm (last accessed on March 3, 2007)

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enormous interest in the financial sector, and the movement of investors, politicians, and ordinary individuals into banking had important implications for the distribution of wealth in the country.

Although senior military officers and politicians could use their contacts to obtain a banking license, these military officers and politicians did not take on executive positions in those banks. As Lewis and Stein (2002) note, government could "allocate licenses and wield some regulatory controls, but they could not regulate access to money markets, secondary foreign exchange markets, or private customers" (p. 25). The generation of managers and senior executives who managed the new banks found in banking an opportunity to build the level of wealth and economic power that would have been impossible in other sectors.[25] The emergence of an economically buoyant new generation of Nigerians marked the beginning of shifts in the balance of power in the country.

The dynamism of the young bankers, combined with a newfound economic power made many of them important community leaders in a society marked by glaring class divisions. Today, Nigeria's banking industry is largely sanitized and stable, but some of the then *new generation* bankers have already acquired enormous wealth and many have metamorphosed into *new breed* politicians, important opinion leaders, and senior advisers to the federal government.

The deregulation of entry into banking also provided opportunities for various ethnic groups to enter the lucrative banking business. Prior to liberalization, the Yorubas of Western Nigeria dominated the banking industry, although regional banks existed in

[25] In private interviews with bankers in Lagos and Port Harcourt, many felt this was the only benefit the society derived from financial liberalization – sharing of the 'national cake' to include people outside of the military/political class.

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Eastern and Northern Nigeria as well. Liberalization provided an opportunity for a significant number of Igbos and other Southeastern minorities to establish a strong presence in the lucrative Lagos financial market (Lewis and Stein, 2002). Similarly, Northerners also made inroads into the financial market through directorships and ownership of some of the new banks. As noted in Lewis and Stein, liberalization helped to dilute the Yoruba control of the financial sector in Nigeria.

Financial liberalization induced a sort of revolution in the banking industry, though perhaps not the one envisaged by the proponents of liberalization. Prior to 1987, a crop of men and women who basically carried out government directives dominated the commercial banking sector. Bank managers were mostly elderly men who rose through the ranks to become managers after many years of service. Most of these managers had no post-secondary education, but had gained practical experience through decades of manual bookkeeping. Following financial liberalization, the new banks came up with a different orientation to banking. When in the early 1990s Diamond Bank and Citizens Bank (two new generation banks) introduced on-line real-time technology that enabled customers of one branch to transact business in another branch, it became clear that the industry was set for major changes.

The new banks declared huge "paper" profits, built magnificent structures, paid mouth-watering salaries and provided other incentives to employees. As investors migrated into banking, workers who could get a job in the banks also migrated from every other sector into banking. Although the boom did not last for a long time before the banks began to fail, the face of banking in Nigeria was permanently changed and the economic power of bank executives continues to increase.

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Initially, the fraud and private wealth accumulation fostered by deregulation of the banking sector generated instability in the sector and had a negative impact on the economy in general. However, the liquidation of failed banks and other initiatives, such as the prosecution and imprisonment of some fraudulent directors and managers in the failed banks, have helped to bring back some level of stability to the sector and in 2004 the CBN introduced a 13-point reform program to aid further stability and development. Prominent in the 2004 reform program are the increase in the minimum capital requirements for banks from N2 billion to N25 billion with effect from December 31, 2005, and the consolidation of the banking sector through mergers and acquisition (CBN, 2004). Although it is too early to evaluate the impacts of the latest reforms, one effect of the exercise has been the reduction in the number of banks from 89 in 2004 to 25 as at December 2005. Of the 25 banks currently operating in Nigeria, Nigerians own 21 and foreigners own 4.[26]

The consolidation of Nigeria's banking sector has highlighted the level of economic power of the new generation bankers. As banks struggled to meet the N25 billion capital requirements, mergers and acquisition became a necessity for banks that were unable to provide the required capital. Through mergers, acquisition and outright take over, the successful new breed bankers have created a stranglehold over the Nigerian banking sector. Of the 21 surviving banks owned by Nigerians, only 4 (First Bank, Union Bank, Wema Bank, and Afribank) had their roots in the pre-liberalization era and only these banks have retained the old generation bankers in the board and management. The remaining 17 are made up of new generation banks established after 1989 and old

[26] See text of a speech delivered by Professor Charles Soludo, Governor of the Central Bank of Nigeria at a press conference on "The Outcome of the Banking Sector Recapitalization and the way forward for the Undercapitalized Banks" held in Abuja on January 16, 2006

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generation banks acquired by the new generation bankers. For example, the United Bank for Africa (UBA), which has its roots in the pre-liberalization days merged with a new generation bank – Standard Trust Bank – and the management of Standard Trust Bank took over management of the new UBA after the merger. Currently, the new breed bankers (all of which rose to prominence in the mid-1990s) control the Nigerian banking industry.

Financial liberalization "liberalized" access to wealth and power outside the military and political elites. The rise in economic importance of bankers has made the banking elite an influential force in Nigeria's political economy. According to an interview respondent, "deregulation of the banking sector helped us to define our future without having to resort to the government for our daily bread. I think banking liberalization is one good thing the Babangida government gave to this country." With the current stable banking industry, bank executives who survived the bank failures of the 1990s have cleaned up their acts and are operating in a more organized environment. But it was liberalization and the perverse incentive it created that offered these bankers an entry point into the world of finance.

The influence of the bankers has spread to other areas, including politics and other sectors of the economy. In 2005 some executive officers of the new generation banks teamed up with a few businessmen to set up what would become the largest private corporation in Nigeria, Transnational Corporation of Nigeria Plc (Transcorp). Transcorp currently has interests in the telecommunication, energy, and hospitality industries in Nigeria. The corporation's mission is "to serve the global markets with premier products

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and services from world class facilities based in Nigeria and managed by Nigerians."[27] The corporation wishes to be in Nigeria what the *grupos* and the *chaebol* are in Mexico and Asia respectively. The emergence of these elite with strong economic power has completely altered the composition of the wealthy class in Nigeria. Although it is too early to assess the longer-term implications of this restructuring of Nigeria's political economy and elite structure, it may well prove to be the most enduring and significant outcome from financial liberalization.

6.5. Concluding Remarks

A key benefit of financial liberalization in Nigeria was improvements in customer service in the new banks compared to the shoddy treatment meted to bank customers during the pre-liberalization era. This improvement in customer service was facilitated by the application of modern technology in banking. As the new banks introduced computers into banking operations, the use of manual ledgers and its associated delays in processing customers' requests were eliminated. Whether this change in technology was caused by liberalization, or simply a reflection of the global transmutation towards modern technology during the last two decades, is outside the scope of this study.

This study corroborates the finding in Ayogu, Emenuga, and Soludo (1998) who note that financial liberalization in Nigeria "increased the scope, but not the depth of the financial system" (p.118). By most measures of financial development, liberalization did not produce significant gains, as most banks had nothing to do with the productive sectors, focusing mostly on traders interested in buying foreign exchange within the

[27] See Transnational Corporation of Nigeria Plc corporate information, available on http://www.transcorpnigeria.com/corporateinformation/index.php?pageid=3&pid= (last accessed March 5, 2007)

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parallel market. Increased activities in the banking industry did not lead to significant improvement in the quality of financial intermediation; neither did it enhance most indicators of financial sector performance. However, the volume of savings as a percentage of GDP increased on average during the reform period.

It is useful to note that the process of financial liberalization in Nigeria was marked with several policy inconsistencies, including intermittent abandonment and reversals of several aspects of the policy. It may therefore appear logical to argue that Nigeria's implementation of the reforms was faulty and as such, the failure of liberalization to produce intended outcomes was not necessarily a problem of the policy itself. As logical as this argument may seem, the haphazard and inconsistent implementation of the reforms in Nigeria should have been predictable at the outset given the institutional environment in the country at that time. Datta-Chaudhuri (1990) captures this succinctly in the following observations: "... one often hears people talking about 'a good plan implemented badly'. This dichotomy between the formulation and the implementation of a plan is usually false. If a plan is supposed to be a feasible action program, then it must have been designed on the basis of realistic assumptions regarding the expected behavior of economic agents. Difficulties regarding implementation should arise only from unanticipated exogenous shocks" (p. 23).

Designing a policy without due recognition of the dynamic interactions between economic agents, and ignoring the nature and strengths of prevailing institutions in a given environment, is likely to produce perverse consequences. Perhaps it is proper to infer from the views of Datta-Chaudhuri quoted above that Nigeria's failure to implement the reforms consistently is basically a reflection of the failure of the policy to account for

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institutional endowments, operating environment, and relevant political and social structures in the country. Otherwise the tenuous social, political, and economic structure in Nigeria during the 1980s, and the high level of official corruption in the polity should have raised serious questions regarding the feasibility of implementing financial liberalization in Nigeria at that time.

However, evidence from other countries adjudged to have implemented liberalization as prescribed does not suggest that financial liberalization would have produced significantly different results if implemented accordingly in Nigeria. In Ghana and Malawi, two African countries deemed to have implemented financial reforms in an orderly manner (without the stop-go approach observed in Nigeria), the results of liberalization in these countries are not significantly different from what obtained in Nigeria (Aryeetey and Senbet, 2004). There has not been a significant improvement in financial intermediation in these countries; neither did liberalization result in improvements in most indices of financial deepening and economic growth. A similar conclusion is made in Demirguc Kunt and Detriagache (1998), who show that liberalization increases the likelihood of financial crises irrespective of the sequence.

Proponents of financial liberalization suggest that liberalization will curb official rent seeking by relaxing government controls over the financial sector. As this chapter demonstrates, this was not the case in Nigeria. Indeed, liberalization worsened rent seeking and led to distress not only in the financial sector, but also in the entire economy. The effects of financial liberalization in Nigeria seem to corroborate the view that a culture of stable rents where the rules of the game are known with certainty could be more conducive to good economic performance than an environment of unstable rents,

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marked with policy inconsistencies. Overall, the Nigerian experience raises serious questions about the classical assumption that liberalization, or simply the market, would solve society's problems and produce efficient outcomes. Based on the results of this study, it is appropriate to restate what has been said in the past: most of the perverse consequences of financial liberalization in Nigeria arose because the package failed to take cognizance of the country's peculiar institutional characteristics at that time.

Financial liberalization created a new class of financially buoyant Nigerians outside the traditional military/political class. At a time of rising unemployment and a general loss of faith in the Nigerian state, the licensing of new banks and the arbitrage opportunities provided by a dual foreign exchange market helped to partially redistribute the country's wealth from the military/political elites to private citizens. Although this form of redistribution may not be the most equitable, it helped to create an economically powerful class of individuals, many of whom have lately metamorphosed to important figures in both the political and economic affairs of Nigeria.

Liberalization provided a window of opportunities for the emergence of some dynamic young men and women who used the opportunities offered by banking deregulation to rise to national and international prominence. This group of bankers is largely made up of the more skilled players who had a semblance of professionalism (or simply, who were not convicted of financial crimes) during the turbulent years of banking crisis. In a sense, then, financial liberalization has led to the supplementation of traditional elite structures with one based in part on a type of economic meritocracy.

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Chapter Seven

Conclusion

The economic performance of most SSA countries during the past decades has been anything but impressive. The difficulty in attaining appreciably higher levels of economic development in these countries has necessitated a number of economic policies ostensibly designed to bring about economic growth and development. As successive policies have failed to lead SSA to the path of sustainable economic development, there have been several attempts to explain "the problem" with SSA economies and to explore the structure and impacts of some of the policies implemented by various governments in the region. This dissertation aims to contribute to this discourse by exploring financial sector liberalization in SSA.

Shortly after emerging from many years of European colonial exploitation, countries in SSA followed an economic policy of government intervention in all sectors of the economy. Development policies in the newly independent nations were designed along the development paradigm that emphasized active roles for the government in the economy. In accordance with this development model, banks were under the direct control of government. It should be noted that government intervention in the economy had a global appeal in the 1960s and 1970s, and so the practices of SSA governments were not different from what obtained in other regions of the world.

Government intervention in the banking sector in SSA was pervasive. Governments established new commercial banks and used indigenization laws to take

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over majority shareholding in foreign banks operating in the region at that time. Banks were expected to provide loans and advances to merchants according to the development goals of the government. Government also identified priority sectors that benefited from subsidized credit from time to time. Credit decisions in the banks were not guided by commercial considerations, but rather reflected the wishes of the government in power. In general, banks were mere instruments of direct monetary policy.

Government controls over the financial sector and the allocation of credit to priority sectors did not lead to the level of growth envisaged by the newly independent governments. Soon, the hope of economic prosperity in the former colonies was replaced by unprecedented economic difficulties, social and political unrest, civil wars and an excruciating debt burden. It became clear to African leaders that political independence was different from socio-political and economic stability. It also became necessary for SSA countries to undertake some forms of policy reforms in order to reverse the deteriorating economic performance of these countries. However, what was not clear was the type of reform to undertake.

The elevation of neoliberalism to the status of global economic order spilled over to SSA through the IMF and the World Bank. Major global developments such as the loss of faith in development planning and the concomitant ascendance of neoclassical economic models questioned the logic of state intervention and suggested that markets would correct society's problems by checking government failures. Consequently, the SAP was the dominant model of economic development actively supported by the international financial institutions and other western creditors.

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Beginning in the 1980s, governments of SSA countries began to implement financial liberalization and other components of the SAP. Although the timing and pace of financial liberalization differed from one country to another, the central message remained the same – government controls over the financial sector should give way to market forces.

Using data from 30 SSA countries over the period 1973 to 2003, this study has provided cross-country evidence on the determinants of financial liberalization in SSA. A case study of the determinants of financial liberalization in Nigeria has also been presented. In addition, this dissertation has provided analysis of the effects of financial liberalization on the financial sector in Nigeria.

7.2 Summary of Findings

Cross-Country Evidence

1. The presence of IMF program increases the likelihood of financial liberalization in the average SSA country. This result confirms the hypothesis that financial liberalization in SSA typically took place within the context of IMF structural adjustment programs.
2. There is evidence that financial liberalization by a big country in a region (a regional leader) increases the likelihood of liberalization in other countries within the region. This result tends to confirm the learning hypothesis, which posits that a country is more likely to adopt a given policy where such policy has been implemented elsewhere. The regional learning effect could also arise from the competition for foreign capital as countries with the same region compete for foreign capital by adopting policies perceived as investor-friendly.

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3. There is evidence that stable regimes are more likely to adopt financial liberalization than unstable governments. Unstable regimes with frequent regime change are likely to maintain both political and economic controls in order to strengthen the incumbent's hold on the nation.

4. The presence of a large service sector (where the service sector contributes up to 60% of a country's GDP) increases the likelihood of financial liberalization in the average country. During the period of financial repression, the service sector was usually not considered one of the priority sectors for the purpose of subsidized credit. Therefore, it is likely that the service sector may be at the forefront of pushing for financial sector reforms.

5. There is evidence that positive GDP growth reduces the likelihood of financial liberalization in SSA countries. Countries with good economic performance, evidenced by high GDP growth rates, are likely to maintain the status quo as against experimenting with a new policy.

Nigeria's Case Study

6. Like the cross-country evidence, the Nigeria's case study provides evidence that the IMF was a significant factor leading to the implementation of financial liberalization in Nigeria.

7. The case study also suggests that senior policy makers within the Nigerian government (under General Ibrahim Babangida) had a significant influence on Nigeria's decisions to implement financial liberalization. Although the study cannot confirm the exact source of the senior policy makers' beliefs and preferences, it appears that members of the government economic team believed

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that financial liberalization would enhance efficiency in the financial sector and lead to economic growth.

8. Besides the influence of senior policy makers, there was no visible domestic pressure in favour of financial liberalization in Nigeria. Opinion polls conducted in Nigeria showed that a majority of Nigerians strongly opposed the implementation of the SAP and its program components.

The Effects of Financial Liberalization in Nigeria

9. Financial liberalization led to phenomenal growth in the number of banks in Nigeria. However, many of the new banks established in the late 1980s and early 1990s concentrated operations in the large commercial cities of Lagos, Kano, Kaduna and Port Harcourt. Some of the new banks also concentrated on foreign exchange arbitraging by buying foreign currency in the official market and reselling the currency in the black market.

10. On average, savings as a percentage of GDP increased during the reform period. The increase in savings was a result of many factors, including high nominal deposit rates, new savings products introduced by the new banks, and the establishment of community banks that helped to mobilize savings from the rural communities.

11. Although the number of banks increased during the reform period, bank credit to the private sector as a percentage of GDP declined during the reform period. This result was mainly due to the perverse incentive created by a dual foreign exchange market, which made it more profitable for banks to focus on the foreign exchange market instead of conventional intermediation.

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12. Financial liberalization led to improvements in operational efficiency in the banks as the new banks introduced modern technology in banking. Related to operational efficiency were significant improvements in the customer service culture compared to what obtained in the era of financial repression. At least partially offsetting this improvement, however, was the limitation of such services primarily to urban areas.

13. The relative operational efficiency in Nigerian banks during the period of financial liberalization did not lead to improvements in intermediation efficiency. To the contrary, intermediation efficiency worsened during the reform period as the spread between lending and deposit rate increased during the period. This result contradicts the alleged efficiency gains that is purported to result from increased competition arising from the deregulation of entry into the banking sector.

14. Financial liberalization led to bank failures and systemic crisis in the Nigerian banking sector. Weak regulation, poor management, inadequate capital, and fraud were some of the factors that contributed to the failure of many banks. These negative features became pervasive in the Nigerian banking sector mainly because bank regulators could not adequately supervise the number of banks and other financial institutions that came into operation following financial liberalization.

15. Deregulation of the banking sector widened the scope for fraud and selfish wealth accumulation in Nigeria. Unlike the era of financial repression where the politicians, military and senior government officials had exclusive access to wealth by manipulating the instrument of government control to satisfy selfish

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ends, financial liberalization liberalized access to wealth outside the military and political class. Although the political class controlled the issuing of bank licenses, ordinary individuals and professionals assumed executive positions in the new banks. Senior executive officers of banks used the opportunity provided by a deregulated financial market to amass a level of personal wealth that would have been impossible during the era of financial repression. The economic power of the new group of bankers has made it possible for many of them to emerge as important figures in a society where financial riches confer enormous privileges.

7.3 Theoretical and Policy Implications of the Findings

Africa's poor economic performance over the past years has necessitated a number of attempts to explain the causes of such performance. Attempts to explain Africa's inability to achieve economic and social development has given rise to different development policies designed to correct the imbalances that has made it impossible for the continent to achieve development. As successive development policies fail to produce desired results, there are claims and counter-claims on why the policies were introduced in the first place, and why the policies failed to produce desired objectives. While African governments accuse the international financial institutions and other western development agencies of foisting ineffective development policies on the continent, the foreign institutions accuse African government of perpetuating the economic problems of the continent due to bad policies, bureaucratic ineptitude and rampant corruption. For example, commenting on the imposition of development policies on Africa, the former Executive Secretary of the United Nations Economic Commission for Africa, Professor Adedeji, noted as follows:

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> In many cases, our friends and development partners have been either unwilling or reluctant to grant us the elementary right to perceive for ourselves what is good for us and to assist us in realizing our perceived goals and objectives. Often, they appear more interested in foisting on us their own perceptions and goals. When it comes to Africa, the outsiders have always behaved as if they know better than Africans what is good for Africa and the result is that without the needed co-operation and support, Africa has particularly always been derailed from pursuing relentlessly and vigorously the agenda it has set for itself...[1]

On the other hand, the World Bank locates all the problems with Africa on Africa's bad policies and weak government. Commenting on Africa's poor economic performance, the World Bank noted as follows:

> The main factors behind stagnation and decline were poor policies – both macroeconomic and sectoral and emanating from a development paradigm that gave the state a prominent role in production and in regulating economic activity. (World Bank, 1994 p. 20)

In reviewing the determinants of financial liberalization in SSA, this study concludes that external and internal factors contributed to the implementation of financial liberalization in SSA. On the one hand, foreign pressures generated through the conditionalities attached to IMF programs were critical factors that led government of SSA countries to abandon financial repression, which had taken root in the region after political independence. On the other hand, domestic influence transmitted through the ideas and beliefs of senior policy makers in some SSA countries made it possible for such countries to accept IMF conditionalities. The case study of Nigeria presents evidence that, although majority of Nigerians voted against the SAP, the Nigerian government went ahead with the program because senior policy makers in the Babangida government

[1] Quoted in Mkandawire and Soludo (1998), p. 36

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believed the program provided a feasible blueprint for achieving financial sector stability and economic growth.

Results of this study question the usual practice of explaining domestic policy choice in Africa along the "externalist" or "internalist" perspective. By presenting evidence of interaction between external and internal forces, this study highlights the futility of blaming external or internal agents for all the wrong policy choices SSA has made in the past. While we recognize that possession of financial might generally confers more powers, it is also true that responsible governments would not sign on to questionable programs simply to obtain debt rescheduling, foreign loans and other financial assistance.

An analysis of the impact of financial liberalization in Nigeria shows that liberalization did not produce the hypothesized benefits in Nigeria. Instead of fostering stability in the banking sector and enhancing other measures of financial sector development, financial liberalization led to bank failures and created perverse incentives that facilitated fraud and selfish wealth accumulation. However, it is pertinent to note that Nigeria did not implement the program as designed by the IMF. Given Nigeria's inadequate implementation of the program, it is legitimate to at least partially absolve the IMF and its allies of any negative effects Nigeria may have suffered as a consequence of financial liberalization. Like Datta-Chaudhuri (1990), we note that the inability of Nigeria to implement the program as designed signifies Nigeria's lack of preparedness and lack of institutional capacity to effectively implement financial liberalization in the 1980s.

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Without passing judgment on the effectiveness of orthodox financial liberalization, we observe that the negative impact of financial liberalization in Nigeria tend to strengthen the theory of path dependency. Generally, the path dependency theory states that what happens to an economy depends to a large extent on the point of departure. In other words, as Hurwicz (1995) noted, differences in outcomes can arise from differences in initial conditions or events. The initial conditions of a weak regulatory regime, pervasive corruption, and a lack of transparent and accountable political leadership made it likely that deregulation of the banking sector would produce unintended consequences. However, the IMF and other proponents of financial liberalization assumed away these weak characteristics, suggesting that the market would correct all "distortions" in the economy.

Nigeria's experience with financial liberalization underscores the importance of adequate institutions in achieving the goals of economic policies. Without transparent and accountable government, the licensing of new banks in Nigeria was susceptible to abuse. Also, the absence of adequate regulatory institutions made it possible for bank managers to perpetrate gross misrepresentation and overt fraud in the financial sector. Development of the financial sector requires adequate institutions such as sound regulations, independent and knowledgeable regulators and supervisors, information-gathering agency that would provide important data to financial market participants, and an efficient system for the enforcement of financial contracts, among others. Where these institutions are inadequate or non-existent, financial liberalization will likely produce perverse consequences.

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In terms of policy formulation, we note that wrongfully specifying the initial conditions in an environment could undermine the feasibility of any policy initiative however sophisticated such a policy might be. Related to this is the futility of applying universal recipes to the solution of real or perceived problems in every country. Given differences in initial conditions and taking due cognizance of institutional capacities in countries at different levels of development, we suggest that policy makers adopt policies that cohere with the institutional arrangements of the environment. The erroneous assumption that all economies work alike and react to market forces along the same trajectory will continue to lead to policy failures. While more banks may induce greater competition, lead to more efficient intermediation, and increase financial depth in some countries, they produced the opposite results in Nigeria.

This study has demonstrated that financial liberalization produced some unexpected results in Nigeria. By widening access to rent and wealth outside the traditional military and political class, financial liberalization has facilitated the emergence of new elite in Nigeria. While it may be speculative to discuss the long-term effects of the new elite in Nigeria's political economy at this time, available evidence suggests that this class of financially buoyant bank executives are expanding their influence and control to other sectors of the Nigerian economy. The new bank executives have also demonstrated both the willingness and the capacity to strengthen Nigeria's presence in the global financial system. Many of the new banks have expanded to several countries in West Africa, and Zenith Bank recently made history by being the first indigenous Nigerian bank to open an office in London, England. The role of the new elite in the political arena has not been as visible as their role in the business sphere. Exploring

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the trajectory of the new elite in the political arena would be an interesting line of enquiry in the future.

In general, while we recognize the overriding influence of international development agencies in the affairs of SSA countries, we note that governments and policy makers in SSA should not resort to blaming foreigners for all the economic woes of the region. Resorting to externalist arguments or associated dependency and conspiracy theories by Africa's policymakers is tantamount to shirking their responsibilities. Africans should take on leading roles in designing development policies that should work within the peculiarities of their environment. Governments of respective countries should also be bold enough to follow through with development programs without abandoning the programs due to pressures from foreigners. Africa's attempt to chart a homegrown development program was articulated in the Lagos Plan of Action. However, no country followed through with the Plan because the World Bank and foreign creditors opposed its prescriptions. SSA countries' failed attempt at "adjusting" their respective economies to prosperity should make it clear that development cannot be imported from an omniscient benefactor in a foreign land. National development is achieved through conscious planning and good policies relayed and actualized by effective domestic institutions and processes.

In recent times, it has become convenient for Africa's foreign development partners to argue that good development policies that produce impressive results in other parts of the world fail in Africa simply because of Africa's peculiar politics and excessive corruption. African states are assumed to be more porous than states in other continents, and African culture is sometimes labeled as anti-development. These views tend to

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legitimize the arrogance of foreign experts and institutions that have chosen to shoulder the "burden" of Africa's development without Africa's involvement. While we may choose to condemn attempts to blame all policy failure in Africa on Africa's "bad politics and culture", we cannot over-emphasize the need for African states to undertake fundamental changes in institutional arrangements, value systems, orientation to governance, and public sector management. Such changes are critical if Africa is to regain lost opportunities and enhance its competitiveness in the global economy.

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Appendix 1 – Financial Liberalization Index for 30 SSA Countries, 1973 – 2003

(0 = Full Repression, 1 = Partial Liberalization, and 2 = Full Liberalization)

Country	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Angola	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Benin	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Botswana				1	1	1	1	1	1	1	1	1	1	1	2	2
Burkina Faso	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Cameroon	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Central African Republic	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Chad	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Côte d'Ivoire	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Dem. Republic of Congo	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Equatorial Guinea	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Ethiopia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Gabon	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Ghana	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Kenya	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1	1
Lesotho										1	1	1	1	1	1	1
Malawi	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Mali	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Mozambique	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Namibia																
Niger	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Nigeria	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
Senegal	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
South Africa	1	1	1	1	1	1	1	1	1	2	2	2	2	2	2	2
Swaziland	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Tanzania	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
The Gambia	0	0	0	0	0	0	0	0	0	0	0	0	1	1	1	1
Togo	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Uganda	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Zambia	0	0	0	0	0	0	0	0	0	0	0	0	1	1	1	0
Zimbabwe	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

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Appendix 1 – Financial Liberalization Index for 30 SSA Countries, 1973 – 2003

(0 = Full Repression, 1 = Partial Liberalization, and 2 = Full Liberalization)

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Angola	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Benin	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Botswana	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Burkina Faso	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Cameroon	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Central African Republic	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Chad	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Côte d'Ivoire	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Dem. Republic of Congo	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Equatorial Guinea	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Ethiopia	0	0	0	0	0	0	0	0	0	1	1	1	1	1	1
Gabon	0	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Ghana	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Kenya	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2
Lesotho	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Malawi	1	1	2	2	2	2	2	2	2	2	2	2	2	2	2
Mali	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Mozambique	0	0	0	0	0	1	1	1	1	1	1	1	1	1	1
Namibia					1	1	1	1	1	1	1	1	1	1	1
Niger	1	1	1	1	1	1	2	2	2	2	2	2	2	2	2
Nigeria	1	1	1	0	0	0	2	2	2	2	2	2	2	2	2
Senegal	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
South Africa	2	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Swaziland	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Tanzania	0	0	1	1	2	2	2	2	2	2	2	2	2	2	2
The Gambia	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Togo	1	1	1	1	2	2	2	2	2	2	2	2	2	2	2
Uganda	0	0	0	1	1	2	2	2	2	2	2	2	2	2	2
Zambia	0	0	0	1	1	2	2	2	2	2	2	2	2	2	2
Zimbabwe	0	0	2	2	2	2	2	2	2	2	2	2	2	2	2

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Appendix 2

STATA Program for chapter 3

```
rename var3 depvarb1
rename var4 demscore
rename var5 autoscore
rename var6 polity2
rename var7 durable
rename var8 svalueaddgdp
rename var9 imports
rename var10 exports
rename var11 gdp
rename var12 tradeopenness
rename var13 gdpgrowth
rename var14 recession
rename var15 currentacc
rename var16 pchcurrentacc
rename var17 bopcrisis
rename var18 inflatrate
rename var19 exchrate
rename var20 debtservice
rename var21 reserves
rename var22 imfsba
rename var23 imfseff
rename var24 imfssaf
rename var25 imfsesaf
rename var26 imfysba
rename var27 imfyeff
rename var28 imfysaf
rename var29 imfyesaf
rename var30 imfmem
rename var31 rlibor
rename var32 yrsoffice
rename var33 polorientation*


gen recession1=(gdpgrowth<0 & gdpgrowth>=-10) if gdpgrowth~=.
label var recession1 "Recession"
gen depression=(gdpgrowth<-10) if gdpgrowth~=.
label var depression "Severe Repression"
gen dum_hinfl=(inflatrate>50 & inflatrate<=100) if inflatrate~=.
label var dum_hinfl "High Inflation"
gen dum_hyperinfl=(inflatrate>100) if inflatrate~=.
label var dum_hyperinfl "Hyperinflation"
gen changereserves=(reserves-reserves[_n-1])/reserves[_n-1]
gen pchangereserves=changereserves*100 if changereserves~=.
gen bopcrisis1 = (pchangereserves<-10) if pchangereserves~=.
label var bopcrisis1 "Balance of Payment Crisis"
label define crisislbl 0 "no crisis" 1 "crisis"
for varlist recession1 depression BOPcrisis1: label values X crisislbl

gen dum_autocracy = (autoscore>=6) if autoscore~=.
label var dum_autocracy "Autocratic Government"
gen dum_stable = (durable>=20) if durable~=.
label var dum_stability "Politically Stable"
```

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```
gen highopenness = 0 if tradeopenness~=.
replace highopenness=1 if (tradeopenness>75 & tradeopenness~=.)
gen dum_hservsector =(svalueaddgdp>60) if svalueaddgdp~=.
label var dum_hservsector "High Service Sector"

gen imf=0 if (imfysba~=. & imfyeff~=. & imfysaf~=. & imfyesaf~=.)
replace imf=1 if (imfysba>0 | imfyeff>0 | imfysaf>0| imfyesaf>0.)
label var imf "IMF Program"

gen nsbaimf=0 if (imfyeff~=. & imfysaf~=. & imfyesaf~=.)
replace nsbaimf=1 if (imfyeff>0 | imfysaf>0| imfyesaf>0.)


gen chlib=depvarb1-depvarb1[_n-1] if depvarb1~=.
gen libz=0 if chlib<=0 & chlib~=.
replace libz=1 if chlib>0

gen replib=2 if libz==1 & depvarb1==2
replace replib=0 if libz==0 | depvarb1==1

gen partlib=1 if libz==1 & depvarb1==1
replace partlib=0 if libz==0 | depvarb1==2

gen librank = replib + partlib


***created in excel "leadlib"***
gen chleadlib=leadlib-leadlib[_n-1] if leadlib~=.
gen leadliberal=0 if chleadlib>=0 & chleadlib~=.
replace leadliberal=1 if chleadlib<0
gen leadfullliberal=(chleadlib<0 & leadlib==0 & chleadlib~=.)

gen imfbopcrisis=imf*bopcrisis1
gen imfright=imf*right
gen topenbop=bopcrisis1*tradeopenness
gen inflatreserves=inflatrate*reserves
gen topenlibor=tradeopenness*rlibor
gen bopstable=bopcrisis1*durable
gen imfhinflat=imf*dum_hinfl

gen lbopcrisis1=bopcrisis1[_n-1]
gen lrecession1=recession1[_n-1]
gen ldepression=depression[_n-1]
gen linflatrate=inflatrate[_n-1]
gen ldum_hinfl=dum_hinfl[_n-1]
gen ldum_hyperinfl=dum_hyperinfl[_n-1]
gen lgdpgrowth=gdpgrowth[_n-1]
gen lgdp=gdp[_n-1]
gen limf=imf[_n-1]

gen tbopcrisis1=bopcrisis1[_n-2]
gen trecession1=recession1[_n-2]
gen tdepression=depression[_n-2]
gen tinflatrate=inflatrate[_n-2]
gen tdum_hinfl=dum_hinfl[_n-2]
gen tgdpgrowth=gdpgrowth[_n-2]
```

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```
gen tgdp=gdp[_n-2]
gen timf=imf[_n-2]


***Equation 1 Table 3.3***
oprobit librank imf gdpgrowth reserves tradeopenness svalueaddgdp
polity2 durable rlibor leadliberal if lagdepvarb1~=2, cluster(id)

***Equation 1 (IMF without SBA - not reported)***
oprobit librank nsbaimf gdpgrowth reserves tradeopenness svalueaddgdp
polity2 durable rlibor leadliberal if lagdepvarb1~=2, cluster(id)

***Equation 2 Table 3.4***
oprobit librank imf recession2 bopcrisis1 dum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Equation 3 Table 3.5 (introduce 1-yr lags of the some variables in
Equation 2)***
oprobit librank limf lrecession2 lbopcrisis1 ldum_hinfl2
dum_hservsector tradeopenness polity2 dum_stable leadliberal if
lagdepvarb1~=2, cluster(id)

***Equation 4 (introduce 2-year lags in the crisis variables)***
oprobit librank imf trecession2 tbopcrisis1 dum_hservsector tdum_hinfl2
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Equation 5 Table 3.6 (interacting some variables)***
oprobit librank imf  imfrecession2 imfbopcrisis imfhinflat
dum_hservsector topenbop imfpolity2 rlibor leadliberal if
lagdepvarb1~=2, cluster(id)

***Estimating Equation 2 without IMF - Table 3.8***
oprobit librank recession2 bopcrisis1 dum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Others Interactions (not reported)***
oprobit librank imf   recdurable  bopdurable rlibor  dum_hinfl
imfpolity2 leadliberal topenbop dum_hservsector if lagdepvarb1~=2,
cluster(id)

***Sensitivity Tests***
***Equation 1 Table 3.3 (reported as Table 3.7)***
probit libz imf gdpgrowth reserves tradeopenness svalueaddgdp polity2
durable rlibor leadliberal if lagdepvarb1~=2, cluster(id)

***Equation 1 (IMF without SBA - not reported)***
probit libz nsbaimf gdpgrowth reserves tradeopenness svalueaddgdp
polity2 durable rlibor leadliberal if lagdepvarb1~=2, cluster(id)

***Equation 2***
probit libz imf recession2 bopcrisis1 dum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)
```

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```
***Equation 3 introduce 1-yr lags of the some variables in Equation
2)***
probit libz limf lrecession2 lbopcrisis1 ldum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Equation 4 (introduce 2-year lags in the crisis variables)***
probit libz imf trecession2 tbopcrisis1 dum_hservsector tdum_hinfl2
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Equation 5 (interacting some variables)***
probit libz imf  imfrecession2 imfbopcrisis imfhinflat dum_hservsector
topenbop imfpolity2 rlibor leadliberal if lagdepvarb1~=2, cluster(id)

***Estimating Equation 2 without IMF ***
probit libz recession2 bopcrisis1 dum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

***Marginal effects***
mfx compute, predict(outcome(1))
mfx compute, predict(outcome(2))


***Predict Tests***
predict predimf
gen pred1=predimf>.5 & imf==0
gen pred2=predimf>.5 & imf==1
gen pred3=predimf>.25 & predimf<=.7 & imf==0
gen pred4=predimf>.25 & predimf<.7 & imf==1
gen pred5=predimf>.1 & predimf<=.25 & imf==0
gen pred6=predimf>.1 & predimf<=.25 & imf==1

***To test for differences in means of the predict***
ttest pred1 = pred2
ttest pred3 = pred4

***Biprobit***
biprobit librank imf recession2 bopcrisis1 dum_hinfl2 dum_hservsector
tradeopenness polity2 dum_stable leadliberal if lagdepvarb1~=2,
cluster(id)

biprobit librank  dum_hservsector recession2 bopcrisis1 dum_hinfl2
tradeopenness polity2 dum_stable imf leadliberal if lagdepvarb1~=2,
cluster(id)

biprobit librank hgdpgrowth recession2 bopcrisis1 dum_hinfl2
dum_hservsector tradeopenness polity2 dum_stable leadliberal if
lagdepvarb1~=2, cluster(id)
```

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Appendix 3 – Description of Interview Process

The interview process began with preliminary identification of individuals and organizations that would provide relevant information on financial liberalization in Nigeria. These key informants were grouped into the following categories: regulators/government, industry practitioners, and bank clients. The regulators included officials of the Federal Ministry of Finance (FMF), the Central Bank of Nigeria (CBN), and the Nigeria Deposit Insurance Corporation (NDIC). Bankers in both the old and new generation banks are categorized as industry practitioners. Bank clients are made up of businesses and individuals who use banking services. Businesses include members and non-members of the Chamber of Commerce as well as non-members of the Chamber of Commerce.

I drew up a preliminary list of individuals/offices to be interviewed. This exercise benefited immensely from my extensive knowledge and network within Nigeria's banking sector where I had worked for several years. A former Director at the FMF also provided valuable assistance in identifying potential key informants in the FMF and the Central Bank. I used the following criteria to determine who should be interviewed:

- FMF officials must be those who were involved with the Structural Adjustment Program (SAP) in Nigeria. These included, among others, individuals who worked with the Minister of Finance and Economic Development at the time SAP was implemented in Nigeria. Given that the SAP was introduced in Nigeria about 20 years ago, many senior officials who were principal actors at the FMF during that period had retired. I had the privilege of identifying some of the retired officials through a retired Director of the FMF. Current officials of the Ministry

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who work directly or indirectly with the financial sector were included. Also included were officials who work in the Economic Development unit.

- At the CBN, the interviews focused on senior officials of the Financial Institutions Division and the Research Department. I paid special attention to those officials who were around prior to, and during the period of financial liberalization. These included bank examiners, supervisors, compliance staff, and researchers working on the financial market. To qualify as a candidate for interview, an individual must have worked, now or in the past, with the banking sector (including researchers in the sector), and must have understood the meaning of banking sector liberalization.
- The NDIC was set up in 1989 to complement the CBN in supervising the activities of banks in the country. As with the CBN, senior officials of the NDIC were the preferred candidates for interviews. These included managers and field examiners who were directly involved in on-site and off-site examination of banks.
- I identified three 'old-generation' banks and five 'new-generation' banks for the interview process. The bankers selected were to provide information on the evolution of the banking sector, the impacts of liberalization, and an overview of the operating environment during the era of financial repression and during the period of liberalization.

After the preliminary identification of potential candidates for interview, I applied to Carleton University Ethics Committee for approval to conduct the research in Nigeria. In June 2005 I received approval from the Ethics Committee to conduct the interviews.

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Thereafter, I made preliminary contacts and sent out introduction letters from the School of Public Policy and Administration to individuals and offices I had identified.

The Interview

At the beginning of each interview, the interviewees signed a consent form approved by Carleton University Ethics Committee. The signing of the form was followed by an introduction and explanation of the purpose of the interview. Interviewees then decided their preference – either to allow me to tape record the interview or to direct me to take notes only.

The interview questions were open-ended. Although the sample questions below were prepared in Ottawa during the preparatory stages, interviews did not follow a rigid structure. The aim was to encourage the interviewee to provide elaborate answers, if possible, to initial and follow-up questions. The interview was, therefore, designed as "guided conservation" around the determinants and impacts of financial liberalization in Nigeria. The rationale for using this form of interview was to enable me to generate detailed responses from the interviews. It also makes it easier for the interviewer to probe inconsistencies, and to test rival explanations. The following are sample questions:

Sample Questions

Central Bank/NDIC Officials + Ministry of Finance

1. In your opinion, why did Government introduce financial liberalization in Nigeria or what forces led to the introduction of financial liberalization in Nigeria (i.e. who were the major actors)?

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2. How would you rate Nigeria's implementation of financial liberalization? Do you think the government followed through with the program consistently? If not, why?
3. How did the policy affect your job?
4. One of the classic arguments for financial liberalization is that liberalization leads to increase in savings and productive investment. In your opinion, and based on your experience, do you think liberalization enhanced savings and increased productive investment in the economy?
5. What are the effects of financial liberalization on the financial sector in Nigeria?
6. What are the effects on the economy generally? How would you describe its impacts?
7. What factors, do you think, influenced the observed outcomes of financial liberalization?

Industry Associations/Bank Clients

8. What were the effects of financial liberalization on the availability of financial services to members of your association (or your business)?
9. Did firms and businesses in your group experience enhanced access to credit and other financial services following financial liberalization?
10. Do you think liberalization affected the productivity and profitability of your member organizations? Why/How?
11. What factors influenced the observed outcomes?
12. Who, or which sector benefited most from financial liberalization, and why?

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13. In your opinion, what factors led to the implementation of financial liberalization in Nigeria? Who were the major actors?

Bankers

14. How did financial liberalization affect your bank's overall services?
15. How did liberalization affect competition among the banks? Did you experience any impacts on the cost of services, fees, lending costs, and interest rate spread?
16. What impact did liberalization have on availability of credit to the private sector?
17. Did your bank observe any impact on savings and investment?
18. Did financial liberalization bring about more or less regulation from the authorities?
19. In your opinion, what factors led to the implementation of financial liberalization in Nigeria? Who were the major actors?
20. In your opinion what were the main results of financial liberalization in Nigeria? Why did liberalization produce the observed outcome? What would have made a difference in the outcome?

Problems

The major problem I encountered during the interviews involved reluctance and suspicion on the part of the interviewees. Some of the people who had earlier agreed to talk to me changed their minds a few days before the interview. Others sought for assurances from me (and from my uncle who works in one of the offices!) that their names and/or office would not be made available to anybody. It was obvious that some interviewees were concerned about confidentiality. Almost all respondents preferred that I take notes instead of using tape recorder.

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A potential problem with the process is that some key informants may not have said all they knew because they are afraid they may incur the wrath of some people if certain comments were attributed to their names/offices. It is also possible that some respondents may have given incorrect statements as a way to reduce any perceived risk. To ensure this does not affect this study materially, I have tried to use multiple sources of evidence in the analyses.

Some interviewees answered a few questions and simply directed me to published resources at their respective libraries. Such referrals proved helpful as they enabled me to corroborate other findings from the interview. Overall, the use of personal and informal contacts facilitated the process, making it possible for me to talk to most of the people I had identified.

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